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## *Chapter IV*

### **MACROECONOMIC POLICY UNDER GLOBALIZATION**

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# MACROECONOMIC POLICY UNDER GLOBALIZATION

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## A. Introduction<sup>1</sup>

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Globalization is permanently changing the framework of national macroeconomic policy, offering opportunities as well as posing challenges and constraints. Many developing countries and economies in transition that opened their borders to international trade and private capital flows over the last quarter of a century have experienced crises triggered by the vagaries of the international financial markets. The “creative destruction” expected from the new openness has often been much more destructive than creative, leading to deep recessions and political crises.

Closer integration of national economies into the international trading and financial systems by an increasing number of countries has created a new environment for national policy action. Although countries have lost some degree of freedom in designing and implementing their own economic policies, there has been considerable diversity in macroeconomic policies, both in developed and developing economies, in response to the new challenges arising from globalization and increased interdependence. There has also been a wide variety

of outcomes. By designing and implementing policies at the national, regional and multilateral levels, countries shaped the globalization process itself. From this perspective, globalization is not just the penetration of national markets by internationally-produced goods and foreign capital flows, but is likewise a reflection of policy decisions taken at the national, regional and international levels, including in multilateral processes.

The process of globalization and national policies mutually determine each other, though in an asymmetric way. Smaller industrialized countries, developing countries and economies in transition are less able than the major industrialized economies to influence globalization trends and global economic governance. This asymmetry is particularly noteworthy in the sphere of international monetary and financial relations, where the absence of a rules-based system permits developed countries, with their disproportionate impact, to determine global monetary and financial conditions. The latter include as well the conditionalities attached to the lending operations of the interna-

tional financial institutions. Furthermore, existing rules and practices seek to promote the free movement of industrial goods, money, capital and enterprises, movements that favour advanced countries. They do not encourage the movement of labour, agricultural products or technology, areas where the benefits would be greater for developing countries.

The chapter will discuss the main challenges that globalization and structural reforms are posing to macroeconomic policies in developing

countries. It will discuss the macroeconomic policies needed to provide an environment supportive of growth, investment and technological upgrading, contrasting that environment with recent experiences in a large number of developing countries. In those countries, it will be argued, macroeconomic policies often do not promote progress in development but actually hinder it. Finally, the feasibility of pro-active macroeconomic policies in support of capital accumulation and growth in the era of globalization will be examined.

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## B. Coping with the macroeconomic implications of liberalization and globalization

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### 1. *Financial integration and capital inflows*

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Financial integration is the aspect of globalization that has had the most critical influence on macroeconomic policy in developing and transition economies. It has not only largely determined the framework for macroeconomic policies, especially monetary and exchange-rate management, but it has also set new parameters for thinking on development policies in the broader sense.

During the 1970s, the abandonment of the Bretton Woods exchange-rate system, the expansion of international banking activities, the huge trade imbalances in the wake of the oil shocks and the concomitant increase of international liquidity radically changed the external environment for development. This new environment considerably enlarged the access of many middle-income countries to external finance, which previously had

been provided primarily by official development assistance (ODA), credits from international financial institutions and foreign direct investment (FDI). The Bretton Woods system was based on the premise that large and continued imbalances in the current account were unacceptable and had to be prevented or rectified by adjustments of domestic expenditure and/or by currency devaluation. From the mid-1970s onwards, however, many developing countries were able to obtain credit from private lenders abroad, credit that was then used to finance current-account deficits. The result of this was a rapid accumulation of external debt, which made the indebted countries more vulnerable to external monetary shocks, leading to the debt crisis of the early 1980s.

In spite of this experience, the pressure towards full liberalization of international capital flows persisted, a policy shift that was even more pronounced in the developing economies than in most developed countries (Williamson and Mahar,

1998). Many developing countries substantially reduced or removed capital controls, although they could have retained such measures according to IMF rules. In the mid-1990s the IMF actively promoted an amendment to its Articles of Agreement that would make it compulsory for IMF members to open their capital accounts. This initiative was supported by the IMF Interim Committee at the Annual Meeting of 1997, but the Asian financial crisis and the perceived role played in that crisis by capital account deregulation weakened the support for such a reform. Although opening of capital accounts was not mandatory for IMF members, it was nonetheless undertaken by many developing countries, leading to their effective integration into the international financial markets. This led to two big waves of gross capital inflow, in 1976–1981 and 1990–1997, which were both followed by periods of retraction (1982–1988 and 1998–2002) (fig. 4.1).

The first wave of private capital inflows consisted primarily of bank lending and financed a large part of the current-account deficits resulting from the oil shocks of the 1970s. These deficits increased considerably when interest rates in developed countries soared at the beginning of the 1980s. The subsequent debt crisis forced a severe adjustment of current-account balances through devaluations, particularly in Latin America.

During the second wave, private capital flows to the developing countries occurred in greater part in the form of portfolio investment but, as in the first wave, had as a counterpart increasing current-account deficits. Private capital inflows contracted considerably after the financial crises in Asia and in the Russian Federation. Since 2003, gross private capital inflows have been expanding again but this time the counterpart is not a widening of current-account deficits. Rather, the private capital inflows are accompanied by current-account surplus in many developing countries, and both factors have led to massive reserve accumulation in the receiving countries, implying a large official capital outflow, as these reserves are held in dollar- or euro-denominated assets.

## 2. Domestic financial liberalization

Deregulation of domestic financial markets, including the elimination of credit controls, deregulation of interest rates and the privatization of banks, was a key element in the reform agenda of the 1980s and 1990s and increased the influence of private sector interests on the performance of the financial sector, something considered to be beneficial for economic growth (Patrick, 1966; Shaw, 1973; McKinnon, 1973).<sup>2</sup> This was based on the belief that lifting “financial repression” in the form of interest ceilings would give the right signals for inter-temporal resource allocation, enhance willingness to save and attract additional resources to the banking system. It was assumed that the banking system, following market principles, would allocate these resources most efficiently. Combining this with a liberalized capital account, developing countries would attract financial savings originating in more prosperous economies and thus overcome a major barrier to growth.

Financial deregulation was not applied with the same intensity and rapidity everywhere, yet it had a marked impact on the functioning of the economies concerned. The Latin American experience of early and radical financial liberalization in several countries refuted the idea that such liberalization and the ensuing rise in interest rates would automatically raise the level of savings and improve their allocation. In particular, the bad experiences with financial reforms in the Southern Cone countries during the 1970s might have provided an early warning. These reforms proved to be counterproductive and led to widespread bankruptcies, massive government intervention, nationalization of private institutions and low domestic savings (Díaz-Alejandro, 1985). High interest rates raised the cost of finance for domestic business and investment, while the deregulated banking sector, rather than channelling more credit towards the most profitable investment opportunities, allocated it in large part to non-productive uses such as private and public consumption and speculative activities.<sup>3</sup>

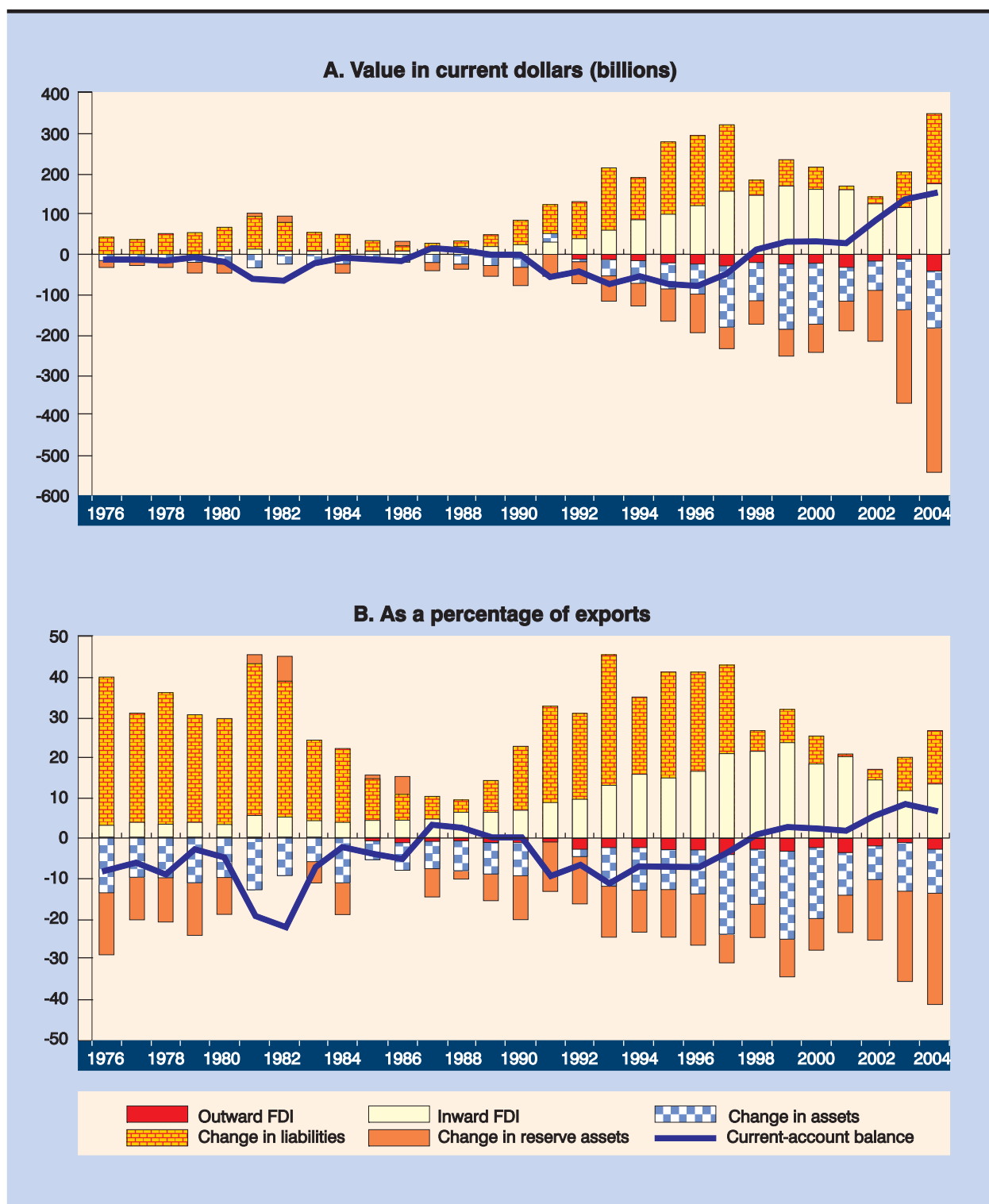
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**Financial liberalization in Latin America did not increase savings and led to extended banking crises, while active financial policies in East Asia enhanced investment and growth.**

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Figure 4.1

**CAPITAL FLOWS AND CURRENT-ACCOUNT BALANCE  
IN EMERGING-MARKET ECONOMIES,<sup>a</sup> 1976–2004**



**Source:** UNCTAD secretariat calculations, based on IMF, *Balance-of-Payments Database*.

<sup>a</sup> Argentina, Brazil, Chile, China, Colombia, Ecuador, India, Indonesia, Kuwait, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, the Philippines, Poland, the Republic of Korea, Romania, Saudi Arabia, Singapore, South Africa, Thailand, Tunisia, Turkey, Uruguay and Venezuela.

In contrast, active government policies in support of financial sector development, rather than deregulation, played an important role in the Asian NIEs: “In most of the rapidly growing economies of East Asia government has taken an active role in creating financial institutions, in regulating them, and in directing credit, both in ways that enhance the stability of the economy and the solvency of the financial institutions and in ways that enhance growth prospects” (Stiglitz, 1994: 50). Credit was directed towards providing long-term investment financing and cheap export financing, while restrictions were placed on consumer credit and the financing of real estate and stock market speculation. Interest rates and bank spreads were subject to government control, and the government also had a direct influence on credit allocation through State-owned commercial and development banks (World Bank, 1993: 225–227 and 273–287).

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Increased interest payments and the loss of fiscal income created serious problems for attaining fiscal equilibrium and compromised public investment.

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and financial liberalization led typically to increased public debt at higher real interest rates. Public debt increased dramatically during currency and financial crises, not only because these crises were accompanied by very high interest rates and currency depreciation but also because, in many cases, the Government nationalised private liabilities and provided costly rescue packages to the financial sector.

Governments had to undertake fiscal reforms in order to adjust to lower income from import taxes resulting from trade liberalization (table 4.1) and in some cases to reduced social security contributions resulting from reforms of the social security system. Privatization led to a reduction of fiscal revenue in a number of

countries. The alternative sources of revenue that increased their share in total current income were value-added tax and other indirect taxes on goods and services, especially in Latin America, and taxes on income and profits, especially in Asian developing countries.

### 3. Changes in the fiscal structure

The scope of macroeconomic policies has also been influenced by the impact that financial integration and reforms undertaken under the aegis of the Washington Consensus had on public sector finances of developing countries. A central element in the reform agenda was a drastic reduction of budget deficits with the intent of achieving fiscal equilibrium. This was seen not only as a key element in stabilization policies, since fiscal deficits and their monetary financing were viewed as one of the main causes of inflation, but also as a key tool for gaining creditworthiness and lowering country-risk spreads in international capital markets.

The composition of fiscal income and expenditure varies widely among developing countries, but it is possible to identify some trends shared by many countries since the 1970s. The most important of these is that the weight of interest payments in total current public expenditure has increased in many countries (table 4.1) as capital account

The effects of these structural changes on fiscal balances and on the ability to pursue active fiscal policies have been mixed. While fiscal administration improved in several countries, increased interest payments and the loss of fiscal income in many cases created serious problems for attaining the objective of fiscal equilibrium and compromised public investment. As a result, several governments are revising some of their previous choices, in particular those regarding taxation of firms exploiting natural resources. They are also re-thinking the question of the direct participation of the State in these activities (see *TDR 2005*, chap. III).

### 4. Exchange-rate and monetary policy

The liberalization of international trade and finance in developing countries during the 1980s and 1990s was undertaken under the heading of “getting the prices right”. However, one of the reasons

Table 4.1

**CENTRAL GOVERNMENT<sup>a</sup> INTEREST PAYMENTS AND TAXES ON INTERNATIONAL TRADE  
IN SELECTED DEVELOPING COUNTRIES, 1971–2004**

(Annual averages)

	<i>Interest payments</i> (Percentage of current expenditure)				<i>Taxes on international trade</i> (Percentage of current revenue)			
	1971–1980	1981–1990	1991–2000	2001–2004	1971–1980	1981–1990	1991–2000	2001–2004
Argentina	8.3	12.6	12.3	28.2	14.6	14.0	6.7	12.5
Chile	5.5	6.6	4.9	5.7	8.0	8.6	8.7	3.7
Dominican Republic	3.4	5.9	8.4	8.5	41.5	33.0	39.6	27.8
El Salvador	2.4	9.3	14.8	11.8	40.8	24.0	13.6	7.9
Uruguay	2.2	7.0	5.9	14.5	10.1	11.4	4.5	4.6
Venezuela	4.4	14.8	18.0	16.8	6.3	12.7	9.0	5.3
Congo	2.1	36.8	36.6	30.0	22.5	12.9	..	6.5
South Africa	8.2	13.1	17.5	14.2	5.2	4.4	3.0	2.7
Tunisia	5.6	10.0	12.6	10.5	23.5	27.1	21.5	8.4
India	13.1	19.5	27.4	27.8	18.2	25.9	22.5	14.9
Indonesia	5.7	18.3	18.0	21.5	12.1	5.2	4.3	3.2
Malaysia	2.6	5.9	3.4	2.9	32.5	20.5	11.8	5.4
Pakistan	1.8	3.6	6.0	6.5	34.2	30.3	21.6	9.5
Philippines	5.8	27.4	27.7	27.0	26.7	23.8	24.1	17.2
Republic of Korea	4.8	7.3	4.2	6.2	14.0	14.2	6.0	4.2
Thailand	10.1	16.7	5.5	7.1	26.9	20.8	14.3	9.7
Turkey	3.8	14.5	24.3	53.5	13.6	6.9	2.9	0.9
Simple average	5.3	13.5	14.6	17.2	20.6	17.4	13.4	8.5

**Source:** UNCTAD secretariat estimations, based on IMF, *Government Financial Statistics Database*.

**a** Fiscal data are presented on a cash basis, with the exception of some recent figures that are only available from the IMF sources on an accrual basis. These are the cases of South Africa (since 2000), Chile and Congo (since 2001), Argentina, El Salvador, Uruguay and Venezuela (since 2002), and Thailand (since 2003). For these countries, the most recent figures are not strictly comparable with the rest of the series.

why the liberalization process may not have delivered the expected benefits for many countries has been the absence of a clear concept of how the most important international price, the exchange rate – and the closely related interest rate –, should be determined or regulated. Many academic observers favoured a market-based determination, arguing for a system of floating exchange rates, but the major financial institutions did not give clear guidance on this key issue. Absolutely fixed exchange rates were found to be as acceptable as systems

of adjustable pegging or pure floating. In the late 1990s, however, following the experience of the Mexican and Asian financial crises, intermediate regimes were increasingly found to be inadequate. For example, in the view of Lawrence Summers – then United States Secretary of the Treasury – “a fixed, but not firmly institutionalized exchange rate regime holds enormous risks for emerging-market economies in a world where fast-flowing capital and insufficient developed domestic financial systems coincide”. It should therefore “in-



creasingly be the norm that countries involved with the world capital market avoid the ‘middle ground’ of pegged exchange rates with discretionary monetary policies” (Summers, 1999).

The two options for national exchange-rate policy that were considered viable, i.e. completely free floating and a completely fixed exchange rate (“hard peg”) came to be known as the “corner solutions”. For a fixed exchange-rate regime to be viable it must be backed by very strong institutional commitments (such as those involved in a currency board) and the country must give up its monetary independence. If the government is not willing to do so, it must opt for a system of free floating. From this perspective, financial globalization presents stringent limits to macroeconomic policy since it is incompatible with an autonomous monetary policy or with the targeting of an exchange-rate level.

The view that emerging-market economies with intermediate exchange-rate regimes were vulnerable to speculative attacks and should move towards either hard pegs or very flexible systems was widely shared, including by the IMF (Mussa et al., 2000: 21–31; Fischer, 2001). It was acknowledged, though, that developing countries could not normally accept sharp variations in their exchange rates with “benign neglect” and might therefore have to intervene in the currency market in order to smooth out exchange-rate movements. However, such interventions were not supposed to tar-

get a pre-determined exchange-rate level or range because this would result in a *de facto* pegging. Such “tightly managed floats” would be susceptible to speculative attacks just like other intermediate regimes. Only free or loosely managed floating would be acceptable as one of the viable exchange-rate regimes in economies integrated into international capital markets. In such a regime, the exchange rate is not providing a nominal anchor to the economy, a role that would need to be played by a quantitative money supply target or an inflation target included as elements of national monetary policy.

Several countries, both developed and developing, that chose a flexible exchange-rate regime adopted “inflation targeting” as the framework for their monetary policy. This entailed not only the definition

of a quantitative target for price changes that are considered acceptable, but also a certain pattern for the assignment of available policy instruments to different goals: the central bank is exclusively in charge of price stability, while other economic goals, such as external balance, growth and high employment, which can be in conflict with price stability, have to be pursued with other policy instruments such as variations in fiscal revenues or expenditures. Against this background, a complementary institutional arrangement consisted in granting the central bank independence from the government (or “operational autonomy”) in order to ensure the credibility of the commitment of the central bank to focus on attaining the inflation target.

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Trade and financial liberalization were achieved without a clear concept of how the exchange rate should be determined or regulated.

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## C. Macroeconomic policies in support of a dynamic investment and growth process

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Capital accumulation is a key variable in sustained growth and structural change. It simultaneously generates income, creates employment, expands productive capacity and carries forward technological progress and productivity gains. However, the occurrence of innovative investment and, more importantly, the occurrence of waves of such investment, is not just the result of the right set of incentives on the microeconomic level; it needs a conducive structural and institutional framework and an appropriate macroeconomic environment that encourages entrepreneurial risk taking and the creation or expansion of productive capacity, with the attendant provision of employment opportunities for increasingly higher qualified workers.

There is a widespread belief that, apart from price stability, the key macroeconomic prerequisite for investment is the availability of savings, and that “foreign savings” are a desirable complement to national savings, allowing the investment rate of developing countries to rise without a reduction in consumption. This static view, which has determined the orientation of macroeconomic policies in many countries over the past quarter century, is not only theoretically flawed (see annex 2 to chapter I), but has also misled governments in their expectations of gains from capital account liberalization.

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**A significant part of capital inflows to developing countries was not channelled towards investment in real productive capacity.**

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### 1. Monetary policy and interest rates

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An increase in net capital inflows following capital account liberalization can temporarily relax balance-of-payments constraints and offers the opportunity to increase imports without a parallel rise in exports. However, experience has shown that such inflows are frequently not used for enhancing productive capacity through higher investment and/or imports of capital goods, practices that would generate the required income to meet debt service obligations. Rather, a significant part of capital inflows to developing countries was channelled through the domestic financial system of emerging-market economies into credit expansion. Rather than helping raise investment in real productive capacity, this boosted consumption or other activities that were either unproductive or not associated with the kind of production that in one way or another could generate the foreign exchange required for debt service.

In the case of Latin America, the expansion of bank lending based on the inflow of foreign savings in the 1990s was accompanied by a shift of such lending from producers of tradable manufactures to the service sector and to households (ILPES, 1998). In other cases, particularly in the

East and South-East Asian countries before their crises in the late 1990s, a higher part of foreign financing reached non-financial agents directly, and in many emerging-market economies domestic credit expansion resulting from increased capital inflows fed speculative bubbles in the stock and real estate markets. This generated highly volatile wealth effects that further encouraged private consumption. Abundant foreign capital was not associated with higher investment rates and better growth performances compared to countries with less dependence on that kind of finance. (Aizenman, 2005: 973).<sup>4</sup>

In an alternative view, higher investment does not depend on the *ex-ante* availability of either domestic or foreign savings, but on the effectiveness of financial intermediation that not only allocates existing financial capital but also channels credit based on newly created money into productive and non-inflationary uses. Indeed, in an economy with a well-functioning banking system, it is the power to create money, and not the supply of loanable funds that generates the power to command the use of real resources for investment purposes. From this perspective, therefore, investment expenditure does not depend on the decisions of savers but on the decisions of central banks and bankers to provide finance to firms that is used to generate investment, higher income and, ultimately, higher savings from that higher income (*TDR 1991*: 93).

Against this background, monetary policy takes on a much broader responsibility than is usually stipulated, as it is playing a key role not only in price and exchange-rate stability but also in the performance of the real sector through its influence on the monetary aggregates and interest rates that determine the availability and cost of investment financing. Moreover, monetary authorities also play a central role through credit regulation and financial supervision. Since all these objectives cannot rely on a single policy instrument, monetary policy has to be complemented by other policies such as fiscal policy, various forms of incomes policy and capital account regulations.

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With additional instruments being employed to achieve price stability, monetary policy could be put at the service of the stimulation of investment and growth.

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In many countries the traditional monetary rule of following a pre-established quantitative target for money supply has been replaced by inflation targeting. To the extent that the inflation target is credible it provides a “nominal anchor” to price expectations, preventing self-fulfilling inflation anticipation. Although inflation targeting does not exclude in principle that monetary policy decisions also take into account other objectives, especially high employment (Bernanke, 2003: 12), in practice it has led price stability to dominate other goals related to growth, employment or the exchange rate. Policymakers often fear that with multiple targets the credibility of the commitment to achieve the inflation target would be undermined, jeopardising the “confidence building” component of the inflation targeting approach.

While monetary policy alone cannot achieve multiple and potentially conflicting objectives, in a pragmatic approach policy priorities may change according to the economic situation, especially with cyclical developments, and monetary policy instruments may be employed for different purposes at different points in time (Frenkel, 2006). Moreover, if additional instruments were employed to achieve price stability, monetary policy could also be put at the service of other objectives, in particular the stimulation of investment and growth. Additionally, with a scheme that rigidly targets the change of the *general* price level, the central bank may over-adjust because changes in certain prices, especially in situations where inflationary pressure results from external price shocks, may not respond to its tools. To avoid excessive adjustment of interest rates and exchange rates, with the attendant adverse effects on the real economy, a more flexible and efficient approach might be to consider the use of “supply side” tools including, for example, government influence on income negotiations and/or the re-definition of the inflation target depending on the origins of the inflationary pressure.

Monetary authorities in developing countries have to manage a financial sector intrinsically

susceptible to boom-and-bust episodes, a propensity that has been reinforced in many countries by financial deregulation and capital account liberalization. The central bank has a key role to play in preventing the succession of episodes of excessive credit expansion followed by excessive contraction. It must not only control the quantity of credit distributed, but also determine how it is used and in which currency it is denominated. Moreover, financial solvency and sustained growth depend on the extent to which credit is financing investment in productive capacity, consumption or the acquisition of real estate and financial assets. Prudential regulation does not always cover exchange rate risks appropriately; for instance, the requirement of a balanced currency composition in banks' assets and liabilities does not keep solvency problems from arising in the case of a sizeable devaluation if borrowers' revenues are derived from domestic sources and their debt is denominated in foreign currency. In other words, monetary authorities have to regulate the quantity of credit and its use by discouraging non-productive and speculative uses within fragile currency systems.

During recessions and crises, the central bank must play its role as lender of last resort to avoid widespread bankruptcies. One of its main objectives should be to avoid systemic financial crises. Tightening monetary policy and raising interest rates in order to attract capital inflows – or to stop capital outflows – has proved to be an extremely costly way of managing crises. Counter-cyclical monetary policy in developing countries is needed as much as it is in the developed world. This does not mean that monetary authorities should be indifferent to capital outflows and currency depreciation, but they should be flexible in both policy instruments and nominal targets by using ad-hoc policy instruments, including capital controls, for curbing capital outflows and by following a flexible exchange-rate policy.

The usual prudential regulations, if rigidly enforced, very often introduce a pro-cyclical bias into the monetary policy stance in emerging-

market economies. In a situation where banks lose deposits and face higher levels of non-performing loans and defaults, banks have to restore their asset/capital and liquidity ratios. However, in a crisis situation it is difficult for banks to raise new capital, and as a result lending typically contracts.

“This naturally further weakens the economy, leading to more bankruptcies and lower net worth, and perhaps an even greater shortfall in capital adequacy” (Stiglitz, 1999: 320).

The more recent modifications of capital requirements introduced in the “Basle II” agreements (BIS, 2005) do not solve this problem. By fixing banks' capital requirements

according to the risk of their assets, this prudential rule reinforces the pro-cyclical bias of bank credit: as the risk of default is negatively related to the economic cycle, the capital needed to meet the requirement will be low and the supply of credit high during expansions, while during recessions, with higher risks, the capital needed to meet the requirement will increase and the supply of credit will contract. A more proper precautionary rule should be to include a supplementary capital provision during expansions in order to constitute a reserve for use during recessions (Aglietta and Rebérioux, 2004: 265–269). Rules that are useful for managing the problems of individual banks in normal times may thus amplify those problems during times of crisis and contaminate the whole financial system. Hence, monetary authorities must avoid aggravating recessions and transforming individual problems into a systemic crisis.

## 2. The exchange rate

The exchange rate is the most important single price for both international financial markets and international trade in goods and services, and it has a strong impact on the domestic price level in small open economies. The exchange rate must be flexible enough to avoid persistent misalignments that would harm the competitiveness of domestic producers and overall trade performance. But at

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The exchange rate must be flexible enough to avoid misalignments that harm the competitiveness of domestic producers and overall trade performance.

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the same time, excessive volatility of the exchange rate must be avoided, as this discourages long-term investment, heightens domestic inflation and encourages financial speculation. Hence, an optimal exchange-rate system must allow different and to some extent conflicting demands to be managed. The choice of an exchange-rate regime reflects not only the policy priorities of a government or a central bank, but also the assumptions about the way in which financial and product markets function.

The exchange rate plays a central role in orientating investment and in determining an economy's balance of payments. As a result of international financial integration, changes in cross-border capital flows, which have reached a considerable magnitude and are often unrelated to investment or international trade in goods and services, increasingly influence the level and variability of exchange rates. Massive inflows of capital exert pressure for revaluation of the local currency. In some cases such exchange-rate appreciation has been welcomed as a means of curbing inflation, and the exchange rate has been used as a nominal anchor for inflation expectations. Sometimes currency appreciation has also been interpreted as an indication of the confidence that participants in the international financial markets have in the respective currency. On the negative side, however, revaluation of the real exchange rate, i.e. currency appreciation overshooting cost and price level differentials, has frequently impacted negatively on competitiveness and growth prospects (Bresser-Pereira, 2004: 16). Exchange-rate misalignment had a particularly negative impact on the outcome of trade liberalization, as local producers were massively handicapped by an overvalued currency (*TDR 2004*).

The "bipolar" view of the options for choosing an exchange-rate regime discussed in the previous section implied that international financial markets would always smoothly adjust exchange rates to their "equilibrium" level. In reality, however, exchange rates under a floating regime have

proved to be highly unstable, leading to long waves of under- or over-valuation with dire consequences for the real economic activity of the economies involved. Moreover, sharp changes in the exchange rate of countries holding a significant external debt tend to generate debt servicing difficulties, liquidity and solvency problems (*TDR 2001*: 114). Due to the specific functioning of financial markets, floating exchange rates produce a most unstable external price level and the price signals for the "real" economy are a substantial source of uncertainty even if hedging for short-run purposes could be further developed. As a result, exchange-rate volatility tends to reduce growth and developing countries are correct in their "fear of floating" (Obstfeld and Rogoff, 1998; Aghion et al., 2006).

On the other hand, "hard pegs" were also based on an unrealistic view of economic adjustment in both product and financial markets. As the exchange rate could not be corrected in case of shocks or clear misalignment, the full weight of adjustment fell on the real sector of the domestic economy: exchange-rate rigidity had to be fully compensated by stronger adjustments in all other markets, mainly via movements in prices and wages. An overvalued exchange rate, for instance, calls for a general deflation in domestic prices and nominal wages. The most consequent forms of a fixed exchange-rate system are a currency board arrangement or full dollarization of the economy. The entry of foreign banks into the domestic banking system was mostly welcomed in this context, since foreign banks were supposed to obtain, in case of a lack of domestic liquidity, foreign financing from their parent company, which would play the role of a lender of last resort, otherwise non-existent under currency board or dollarization.

Experience has shown that fixed exchange-rate systems often end up sacrificing not only growth and employment stability, but also interest rate stability and the stability of the banking system more generally in order to obtain exchange-rate and price stability (ECLAC, 1999: 24). The

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**The exchange-rate regime should provide room for manoeuvre in the presence of instability in international financial markets and allow governments to target a real exchange rate that is in line with their development strategy.**

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exchange rate, rather than serving as a policy instrument, becomes the central goal of macroeconomic policy, which then also requires fundamental structural changes. The collapse of the currency board in Argentina in 2001 has considerably reduced the attractiveness of this strategy and has given rise to a reconsideration of the exchange rate as an instrument variable.

Against the background of experience with both rigidly fixed and freely floating exchange rates, “intermediate” regimes have become the preferred option in most developing countries. According to a recent IMF report, “[t]he persistent popularity of intermediate regimes ... suggests that such regimes may provide important advantages ... that ... are able to capture some of the benefits of both extremes while avoiding many of the costs” (Rogoff et al., 2004: 14). Indeed, developing countries require an exchange-rate regime that provides sufficient room for manoeuvre in the presence of instability in international financial markets, and allows them to target a real exchange rate in line with their development strategy. None of the “corner solutions” offer these possibilities. There is an “impossible trinity”: combining a *completely* open capital account with *full* autonomy in monetary policy and *absolute* exchange-rate stability is indeed impossible. But, given the shortcomings of free floating, developing countries are faced with an “impossible duality” (Flassbeck, 2001): with open capital markets, neither fixed nor flexible exchange rates give developing countries the *de facto* autonomy to conduct monetary policy with an exclusive orientation toward domestic needs. Thus, aiming at a second-best combination appears to be a feasible approach in practice: “It is possible to engage in *selective* capital controls and a *managed*-intervention exchange rate regime which reclaims *some* monetary policy autonomy. *These moves away from the corners create more policy space*” (Bradford, 2005: 5; emphasis in original).

In a world where developing countries focus on creating favourable monetary conditions for the domestic economy rather than on attracting foreign savings, the exchange rate should be compatible with a sustainable balance of payments, i.e. it should allow domestic producers to achieve and maintain international competitiveness so that a surplus in the trade balance can be achieved that is high enough to meet obligations resulting

from debt service and profit remittances.<sup>5</sup> Such a policy could be labelled the “development strategy approach” to exchange-rate management (Williamson, 2003).<sup>6</sup>

Countries trying to maintain the real effective exchange rate within an adequate range will have to intervene frequently in the foreign exchange market even when capital controls are applied. Such intervention may lead to an accumulation of international reserves and the need for sterilizing the effect of this accumulation on domestic monetary aggregates. In the case of massive and prolonged sterilization, the accumulation of public domestic debt resulting from that sterilization could impinge upon a government’s ability to react flexibly to future crises and could involve substantive fiscal cost if there were a significant interest rate differential between the central bank assets and liabilities (Harberger, 1989; Rodrik, 2006).<sup>7</sup> There may also be good reasons to accumulate reserves for “precautionary” purposes, for example as a buffer against the impact of external shocks that today are more likely to result from the capital account than from the trade account of the balance of payments.<sup>8</sup>

### 3. Confidence game or counter-cyclical policies?

In an economic policy approach that focuses on foreign saving as a vital complement to national saving, attracting foreign capital becomes a major policy goal. This is why many countries have set up specific policies to attract foreign capital, including favourable tax conditions for FDI and portfolio investment, and have played “the confidence game” by taking macroeconomic policy measures “that may not make sense in and of themselves but that policymakers believe will appeal to the prejudices of investors” (Krugman, 1998). In Latin America, for example, policies were seen as “credible” only if the international financial markets believed in their consistency and adequacy (Bresser-Pereira, 2001) and responded with increased lending and lower country-risk premia. Typically, policies aimed at gaining confidence among financial market participants were trying to provide profitability and predictability

in this area through market-established interest rates, low inflation and stable exchange rates. Strong domestic growth and the soundness of the development strategy were not necessarily part of that strategy. Confidence-building of this kind also determined the policy response in situations of financial and macroeconomic crises, so that policies frequently became pro-cyclical in the midst of economic depression.

Specifically, one of the central elements in IMF-supported programmes designed to cope with a crisis has been fiscal tightening. The Independent Evaluation Office of the IMF found recently that fiscal stances may have been unnecessarily contractive (IMF-IEO, 2003). It was found that adjustment programmes were overoptimistic in their estimates of growth, investment rates and fiscal balance, and that they were overly pessimistic concerning current-account adjustment and reserve accumulation, especially in the “capital-account crisis cases”.<sup>9</sup> Consequently, the targeted external adjustment could have been reached with a much smaller dose of domestic demand restriction. Fiscal balances also fell short of expectations: instead of a planned improvement from 3.3 to 1.8 per cent of GDP, fiscal deficits actually increased to 4.3 per cent of GDP the first year and 3.7 per cent the second year. Thus, measures aimed at reducing fiscal deficits did not only end up with a much higher-than-expected contraction in GDP and investment, but also with higher fiscal deficits.

Seeking the reasons of such miscalculations in gauging the results of the programmes, the IEO did not find a clear rationale supporting pro-cyclical fiscal tightening.<sup>10</sup> Apparently, IMF-supported programmes considered that even in the midst of a crisis lower public expenditure would rapidly crowd-in private investment: “Programs typically assume rapid recovery, and therefore push for greater fiscal adjustment to make room for private investment, whereas a more realistic recognition of the negative impact of crises on in-

vestor expectations would call for a more relaxed stance.” (IMF-IEO, 2003: 47). Generally speaking, the rationale for the pro-cyclical responses during economic crises was to maintain or recover the confidence of financial markets, since the resumption of capital inflows was considered indispensable for stabilizing financial markets, exiting the crisis and resuming growth (Bradford, 2005).

As a supplementary way of building confidence, some countries have tried to enhance the credibility of their macro-

economic orientations by establishing legal restrictions to their policy management. This has been the case, in particular, with fiscal policy: the commitment to fiscal discipline has been instituted in national laws fixing limits to fiscal expenditure and/or to fiscal imbalances, sometimes on a multi-annual basis. An extreme example of such commitments was the “Zero-deficit Act” in Argentina, in 2001, which was intended to ban any fiscal deficit and ensure the servicing of the public debt by automatically adjusting primary fiscal expenditure (excluding interest payments) to current fiscal income. However, if the fiscal rule is excessively rigid, it introduces a strong pro-cyclical bias into macroeconomic management. In effect, if an economic recession affects fiscal income, the “fiscal rule” would command cutting

public expenditure, which might aggravate the economic recession. Since this further reduces fiscal earnings, such a strategy is self-defeating and obtains neither fiscal balance nor credibility.

Explicit commitments aimed at gaining credibility also involved, in several countries, monetary and exchange-rate policies. In currency boards the exchange rate is “irrevocably” pegged to a currency (usually the dollar or the euro) and the Central Bank is committed to “back” the entire monetary base with international reserves. This means that, in principle, monetary supply expands exclusively with the accumulation of international reserves and contracts if those re-

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**Policies primarily aimed at gaining the confidence of foreign investors frequently tend to introduce strong pro-cyclical biases.**

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**Restoring confidence in an economy that is going deeper into recession is an almost impossible task.**

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serves diminish. This strict monetary rule is supposed to guarantee the sustainability of the exchange rate peg and create confidence again.

However, such a passive monetary rule may put the banking system in a dangerous position and unleash speculative attacks instead of preventing them. It is always possible to expand the monetary base as international reserves accumulate while maintaining an unchanged nominal exchange rate. On the other hand, it is impossible to keep selling international reserves beyond the moment they dry out. Most observers expected that a currency board regime would never reach this point since “all the money” is backed by Central Bank reserves. This, however, is only true for the monetary base but is false for wider monetary aggregates, which include time deposits. If domestic investors wish to change their bank deposits into dollars in a critical situation, the loss of deposits would cause a brutal credit deflation, along with further interest rate increases, and would aggravate the economic crisis. Sooner or later, then, the monetary rule must be abandoned and with it the fixing of the exchange rate.

In general, institutional regulations seeking to build credibility by showing the policymakers’ strong commitment to sticking to the announced goals and policies will be unsustainable if these rules introduce a pro-cyclical bias, amplifying growth phases with fiscal and monetary expansions, and aggravating recessions with fiscal expenditure cuts, high interest rates and credit restrictions. Restoring confidence in an economy that is going deeper into recession is an almost impossible task (Stiglitz, 1999: 323).

On the fiscal side, in particular, stabilizing mechanisms should be enhanced or restored. Automatic stabilizers can play an increasingly important role in developing countries. They limit the reduction of demand and output growth in times of recession, when tax revenues normally decrease and social expenditure increases, provided that such changes are not accompanied by offsetting measures such as expenditure cuts in response to lower tax income. Strengthening the stabilizing role of public finances would require a flexible definition of budgetary targets, using expenditure instead of deficit targets (Martner, 2000). Such targets would allow for wider defi-

cits during recessions, and smaller deficits, or surpluses, during expansions. However, this rule should not be applied too rigidly either. Its proper application requires a distinction between cyclical elements of a possible deficit, elements which are transitory and should be permitted; and structural ones, which would not disappear during an upswing and should be avoided. Moreover, it may not be appropriate to save all the extra revenues that occur during upswings. Depending on the state of development and the specific situation of an economy, using such revenues for the acceleration of public investment projects can be critical to enhance supply capacities and, thus, long-term growth perspectives. In other situations, by contrast, the “automatic” element in the fiscal stance may have to be complemented with discretionary measures, especially in countries where institutions do not provide strong automatic fiscal stabilizers.

Reinforcing automatic stabilizers should be a long-term institutional objective, even if it is difficult to implement at early stages of development and in economies with a large informal sector. Another institutional instrument for improving the working of counter-cyclical policies is fiscal stabilization funds, which have been established in several countries.<sup>11</sup> They would accumulate public sector revenues resulting, for example, from temporary commodity booms and release them for sustaining expenditure during slowdowns or in times of depressed prices.

#### **4. Capital controls**

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Macroeconomic policies in countries closely integrated into international markets have to cope with several risks at the same time: that of the misalignment of macroeconomic prices – particularly that of the exchange rate and interest rates; the orientation of a substantial share of capital inflows and domestic credit towards financing consumption and non-tradable production; economic instability arising from the volatility of capital movements and credit-led cycles; and the creation of a debt overhang that may durably hamper both investment and growth.



Globalization has increased the need for pro-active macroeconomic policies in support of growth, but it has also introduced constraints to implementing them. Some of these are *de facto* constraints on monetary and exchange-rate policies in an environment of free capital movements, the “impossible duality” referred to above. Given these constraints, it may be necessary to protect the domestic economy against the impact of the instability of international financial markets on capital accumulation and growth by applying controls on capital inflows or outflows, actions that are within the formal “rules of the game” since they are allowed by the IMF Articles of Agreement.<sup>12</sup>

In a recent survey of 30 empirical studies on the effects of capital controls, four main reasons for their introduction have been identified. First, avoiding exchange-rate appreciation that would reduce competitiveness; second, avoiding an accumulation of “hot money” ready to leave the country at the first perceived sign of difficulties; third, avoiding too-large inflows that might generate asset price bubbles and over-consumption as well as dislocations in the financial system; and, fourth, avoiding the loss of monetary autonomy (Magud and Reinhart, 2006).<sup>13</sup> It is frequently argued that capital controls cannot be effective because they can be easily bypassed. However, Epstein et al. (2004) dismiss four frequent criticisms against capital controls, based on the positive experiences made with such controls, under different circumstances, in Chile, Colombia, Malaysia and Singapore. These experiences do not confirm the belief that the costs of controls in terms of distortions of factor allocation would outweigh the benefits of greater capital account stability. Moreover, the experience of Singapore refutes the argument that capital controls only work in the “short run”, while that of Chile contradicts the notion that such controls have to be increasingly restrictive. Finally, the ex-

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Globalization has increased the need for pro-active macroeconomic policies in support of growth, but it has also introduced constraints to implementing them.

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Capital controls have in many cases alleviated pressure on exchange rates, making monetary policy more independent, and altered the composition of capital flows towards the longer-term variety.

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periences of Malaysia and the Republic of Korea during the Asian financial crisis have shown that capital controls can be effective not only when applied to capital inflows, but also when they are applied temporarily to outflows.

Capital controls can take many different forms. Controls of the administrative type using prohibition, quotas or selective permission, depending on the use of capital, were practiced in many developed countries until the 1980s. Administrative measures can also

take the form of minimum-stay requirements or, as in Colombia, outright prohibition of inflows for specific purposes such as investment in real estate. In developing countries over the last two decades, capital controls have frequently been of the market-based type, using disincentives in the form of taxation or specific reserve requirements.

The better known and most widely accepted form of capital control is the one that was introduced first by Chile and Colombia and more recently by the Russian Federation and Argentina, where a mandatory reserve requirement was imposed on some or all capital inflows. Under this system a significant proportion of the inflow has to be held in a non-interest-bearing deposit at the central bank so that short-term capital movements become less profitable. Thus, surges of capital inflows and the financial fragility resulting therefrom could be tempered, and “policy space” for fiscal and monetary policy was gained.<sup>14</sup> The imposition of temporary restrictions on capital outflows played an important role in stabilizing the exchange rate in Malaysia in 1998, and in Argentina after the 2002 devaluation.

There is a consensus that the Chilean type of capital control did manage to alter the composition of capital inflows in favour of FDI and at the expense of speculative capital movements (Le Fort and Lehmann, 2000). An alternative form was used

by Argentina during the second half of the 1990s, imposing high non-interest-bearing liquidity requirements on domestic financial institutions receiving foreign capital, which discouraged at least those inflows passing through the banking system.

In sum, while capital controls are certainly not a panacea, they have in many cases succeeded in alleviating pressure on exchange rates, making

monetary policy more independent, and reducing the instability of capital flows by altering the composition of these flows towards the longer-term variety. This, in turn, also helped reduce the pressure on exchange rates. Even if intervention to control capital inflows or outflows may to some extent be circumvented, these controls have served as dams to capital flows, avoiding massive flooding and helping to channel capital flows into more productive uses (Stiglitz, 1999: 327).

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## D. Towards a new assignment of policies

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Overcoming the old interventionist developmental state with a revival of markets and market forces, as put forward in the Washington Consensus, has proved to be inappropriate in light of the challenges for developing countries and the imperfections of the global market system. Today, governments in developing countries have to make a distinct choice regarding the economic model on which to build their development strategy.

The history of economic ideas offers two main approaches in the context of a market economy. One centres around the apparent dependence of developing countries on the inflow of foreign savings to support their own limited means to invest and catch up. The other stresses the need to have the right macroeconomic policies and the right institutions in place to create savings in a process of dynamic development. These approaches tend to be mutually exclusive (see annex 2 to chapter I).

The perception that uncompromising stabilization of the price level is the most important condition for satisfactory growth performance dominated for a long time the debate on the sustainable assignment of macroeconomic policy instruments

in both developed and developing countries. Under the heading of “sound macroeconomic policies”, the orthodox monetarist approach that called for measures to avoid inflationary acceleration in the course of cycles and in the wake of shocks, with monetary policy playing the role of a guard-rail for any combination of fiscal and structural policy, was widely accepted. The role of fiscal policy in this assignment was limited to assisting monetary policy by keeping budget deficits low and by minimizing government intervention.

In the most successful cases of economic catch-up price stabilization has also been a key target. However, this target was pursued not only with monetary policy tools but also with heterodox, non-monetary instruments such as incomes policy or direct intervention into the goods and labour markets (Flassbeck et al., 2005). Monetary and fiscal policy was at the service of fast growth and high investment. The preferred instruments were low interest rates and, at least since the Asian financial crisis, a slightly undervalued exchange rate. Fiscal policy was used pragmatically to stimulate demand whenever this was required in light of cyclical developments. Budget outcomes were not considered to be a direct policy target

by themselves but were accepted as the result of an investment-led growth process.

The point of departure of such policies is that investment does not depend on savings that exist at the outset. Therefore, economic policy has to focus on raising investment and income, which will ultimately create the savings required for achieving macroeconomic equilibrium. This approach requires a monetary policy that breaks the orthodox rules, as it provides financing possibilities to enterprises that do not yet exist. As already observed by Schumpeter, it is potentially inflationary but does not actually lead to inflation to the extent that the newly created liquidity finances pioneering companies, real investment and output growth rather than consumption at a given level of income (Schumpeter, 1911).

There is thus a narrow link between catching up and structural change over time, on the one hand, and a country's monetary system on the other. Rapid economic development, initiated and pushed forward by pioneering firms in product markets, is only possible if monetary policy finances this process of capital accumulation in advance. Or as Friedrich von Hayek, one of the leading anti-Keynesian economists put it:

By creating additional credits in response to an increased demand, and thus opening up new possibilities of improving and extending production, the banks ensure that impulses towards expansion of the productive apparatus shall not be so immediately and insuperably balked by a rise of interest rates as they would be if progress were limited by the slow increase in the flow of savings (Hayek, 1933: 177).

This perspective confirms the critical importance of price stabilization: in countries that are prone to high inflation it is much more difficult to start and sustain a process of development and catching up because of the frequent need to tighten the creation of money and credit. Without a sufficient number of policy instruments that can be

used effectively, the attempt to finance development through this creation is likely to fail as inflation rapidly flares up.

Conversely, in countries cultivating a highly disciplined attitude towards price stability by means of heterodox instruments such as incomes policy or the formation of a national consensus on reasonable wage claims, monetary policy can serve to make that kind of financing possible. The crucial task is then to reach social consensus to avoid struggles over income distribution, which become inflationary insofar as unit labour costs overshoot the inflation target. Such a consensus raises the likeli-

hood of rapid economic development and the creation of savings through profits, even if the amount of household savings is negligible. Increasing profits, on the other hand, are made tolerable and sustainable when they are re-invested in large part and when it is ensured that all groups in society receive an adequate share in the rising national income. Monetary policy would step in only under exceptional circumstances, for example when the consensus is threatened during long periods of full or over-employment.

External financing remains necessary to the extent that increasing imports of capital goods as a result of higher investment lead to current-account deficits. But the successful cases of economic catching up, most recently seen in China, have shown that such deficits are not inevitable and that domestic sources of financing investment, including reinvested profits and credit creation in the Schumpeterian sense, can go a long way towards raising growth rates without calling on foreign savings. The decisive factor for catching-up is domestic accumulation of capital as the result of investment, consumption and the creation of rising real income for all groups in the society. If savings are understood to be the result of growth and not its precondition, opening up to the inflow of foreign capital is not always a necessary condition for successful catching-up. However, developing countries need to be able to determine long-term monetary conditions that are conducive to growth and investment. Premature capital ac-

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**Economic policy has to focus on raising investment and income, which will ultimately create the savings required for achieving macroeconomic equilibrium.**

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count liberalization can be an important hindrance to the successful implementation of the profit-investment nexus and to catching up.

However, in low-income developing countries, the domestic financial system often does not allow for an effective transmission of central bank impulses through the banking system to the financing of investment, so that financing through reinvestment of profits or specially-designed development banks has to play the key role. Moreover, most of these countries also depend, either to a large extent or entirely, on imports of capital goods to carry out real productive investment and achieve productivity growth, and these imports have to be financed. As it is precisely these countries that have least access to private financial flows, except for some exporters of hydrocarbons and mining products, they should not play the “confidence game” in order to seek external financing mainly from private capital markets. Rather, the international community should step in with sufficient official financing to fill the gap. The largest possible independence from international capital markets allows central banks to use their instruments for actively pursuing development targets, provided that an acceleration of inflation is checked by non-monetary measures. This is all the more important since these countries, distinct from those that have already acquired a certain manufacturing supply capacity, are also having limited scope to use exchange-rate management as a tool of their development strategy as most of their exports have a relatively low elasticity with respect to price and exchange-rate changes.

In the absence of effective multilateral arrangements for exchange-rate management, macroeconomic policy in many developing countries in the past few years has been geared increasingly toward avoiding currency overvaluation. This has not only been a means for

maintaining or improving international competitiveness, but also a necessary condition for low interest rates and an insurance against the risk of future financial crises. By contrast, a regime of current-account deficits has proved to be very costly in the past, as it has frequently resulted in financial crises. Interest rate hikes, huge losses of real income and rising debt burdens have been common features of all recent financial crises.

A case in point is the policies pursued in China after the financial crisis the country experienced in 1994 (Flassbeck et al., 2005). The absolute and unilateral fixing of the renmimbi against the dollar for more than ten years was possible because

China, notwithstanding large inflows of FDI, did not become dependent on net capital inflows. China was able to fix its exchange rate and at the same time keep its interest rates extremely low despite very high growth rates. It pursued an extremely accommodating monetary policy over the long term, holding interest rates low and intervening massively in the foreign exchange market to keep the exchange rate at a competitive or even undervalued level (fig 4.2).

Many other developing countries were most of the time faced with the uneasy choice between low interest rates fuelling inflation and intervening in a costly way in the currency market to keep the exchange rate stable. Intervention, combined with relatively high domestic interest rates, means paying international speculators with tax-payers’ money or ending up with real currency appreciation and a loss of competitiveness.

China, and before it other newly industrialized economies in Asia, found ways of avoiding an acceleration of in-

flation with non-monetary instruments and institutional arrangements, consisting of an array of different measures ranging from incomes policy to many other kinds of direct government inter-

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**If savings are understood to be the result of growth and not its precondition, opening up to the inflow of foreign capital is not always a necessary condition for successful catching-up.**

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**The various examples of non-monetary measures to curb inflation illustrate that there is no “one-size-fits-all” rule regarding such measures.**

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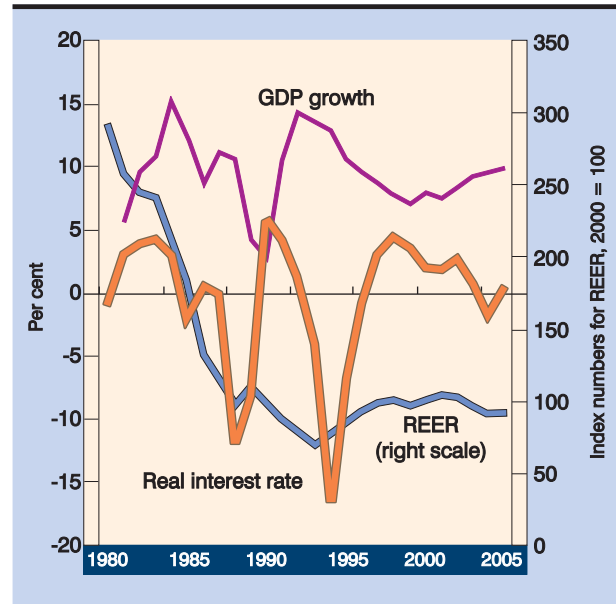
vention into the process that determines prices and, even more importantly, nominal wages. Reacting to an inflationary acceleration in 1994 the Chinese Government, for example, extended its influence on the wage finding process by discontinuing backward looking indexation of wages to inflation and by coupling nominal wage increases much closer to productivity growth. Additionally, price controls and direct intervention into the price setting for crucial prices like electricity, coal and transportation services have been applied.<sup>15</sup>

Along the same lines, Argentina after the recovery following its dramatic currency crisis, rejected recommendations to increase interest rates and to allow for an appreciation of its currency when in the course of its strong recovery the inflation rate rose from 6 per cent in 2004 to 12 per cent in 2005. Instead, the authorities continued to target the exchange rate and the interest rate and sought to control inflation by a variety of instruments like temporary price moderation agreements with associations of producers and wholesale as well as retail distributors. They also intervened into wage negotiations, promoting rather moderate real wage increases. Moreover, the Government restricted meat exports for 180 days to curb the significant domestic price increase of these products, which are of great importance for the consumer price index. Despite the fact that all these measures were applied on a temporary basis, they have succeeded in moderating price expectations and have made it likely to reach the official inflation target between 8 and 11 per cent in 2006.

There are other examples in economic history of such an approach: Japan and Germany in the 1950s and 1960s also successfully combined an expansionary monetary policy stance with undervaluation and heterodox stabilization policies, mainly based on political pressure to keep nominal wage increases in line with productivity growth and the inflation target. The various examples of non-monetary measures to curb inflation illustrate that there is no “one-size-fits-all” rule regarding such measures. The selection of such heterodox measures very much depends on institutional arrangements on the labour and goods markets. For example, the degree of centralization of the wage bargaining mechanism and, closely related, the mobility of the labour force, is decisive for the

Figure 4.2

### MONETARY CONDITIONS AND GDP GROWTH IN CHINA, 1980–2005



**Source:** UNCTAD secretariat estimates, based on IMF, *International Financial Statistics Database*.

**Note:** Interest rates refer to deposit interest rates. REER stands for real effective exchange rate.

effectiveness of government intervention in the labour market. The producer structure of the market for utilities, on the other hand, may be crucial to decide whether intervention in this area may help to achieve the overall inflation target.

The policy mix applied by the Asian NIEs has been complemented by some forms of capital account regulation. While such regulation may help contain and also prevent crises to some extent, the prime objective must be to avoid situations where such regulation becomes necessary, i.e. preventing the emergence of large interest rate differentials, arbitrage possibilities and incentives for speculation in the first place. Low domestic inflation, combined with low domestic interest rates, greatly facilitates the management of short-term capital flows with or without capital controls in place. However, since speculation on currency appreciation, with its concomitant destabilizing inflows of hot money, can never be fully avoided, the hands-on approach towards capital account

management as it has been practiced in the Asian NIEs can be helpful. It is also important for developing countries to use the instruments they have at their disposal for short-term macroeconomic management. Overemphasis on structural problems and on macroeconomic “soundness”, as under the reform agenda of the Washington Consensus, led to neglecting measures aimed at stimu-

lating business activity and investment in the short run. The example of the successful emerging-market economies, including China with its largely incomplete structural reform agenda, also shows that effective macroeconomic management can compensate for many shortcomings in the functioning of markets as well as make up for structural weaknesses. ■

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## Notes

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- 1 This chapter benefited from a background paper prepared by Arturo O’Connell (2006).
- 2 Patrick (1966) distinguished between financial development as a result of economic growth (“demand-following”) and expansion of financial intermediation leading to economic growth (“supply-leading”), while the protagonists of the anti-financial repression literature, McKinnon and Shaw, focused exclusively on the latter.
- 3 At the conceptual level, one of the main academic supporters of financial liberalization, McKinnon, later acknowledged the weak effect of higher interest rates on savings (McKinnon, 1991).
- 4 Aizenman defines a self-financing coefficient as the ratio between gross national savings and gross investment, and finds a direct and econometrically well-established relation between a higher self-financing ratio and higher rate of growth. Latin American countries, with lower self-financing coefficients than the Asian NIEs, also registered lower rates of growth.
- 5 The accumulation of reserves for preserving a competitive exchange rate is what some authors call the “mercantilist view” on foreign exchange accumulation (Aizenman and Lee, 2005).
- 6 There is, of course, a “fallacy of composition” if all countries were pursuing such exchange-rate targets, i.e., there are only  $n-1$  degrees of freedom to set the exchange rates of the  $n$  currencies in the world (see also *TDR 2004* and chapter I of this *Report*).
- 7 This strategy can be sustained more easily the lower the interest rate on the sterilization bond. In China, which has massively accumulated foreign exchange reserves over the past few years, that rate is presently even lower than the interest earned from dollar assets.
- 8 It has been recommended that a level of reserves equivalent to at least the external debt maturing in the coming 12 months should be maintained in order for a central bank to be able to prevent financial crises (Bussière and Mulder, 1999; and Hviding et al., 2004).
- 9 The cases of capital-account crisis considered in this study are Argentina, 1995 and 2000; Brazil, 1998; Indonesia, 1997; Mexico, 1995; the Philippines, 1997; the Republic of Korea, 1997; Thailand, 1997; Turkey, 1994 and 1999. In these countries, GDP contracted (on average) by 5 per cent during the first year of the programme instead of growing by 1.6 per cent as had been envisaged; the investment rate was three percentage points lower than projected; but the current account shifted in just one year from a deficit of 3.4 per cent of GDP in the year before the programme to a surplus of 2.4 per cent, almost five percentage points of GDP more than scheduled in the programmes (which targeted, on average, a deficit of 2.4 per cent of GDP).
- 10 “Surprisingly, the rationale for the proposed fiscal adjustment is not very clear when we look at the 15 individual programs studied in this evaluation. An in-depth examination of staff reports and other Executive Board papers related to these programs often do not explain adequately how the magnitude and pace of the programmed fiscal adjustment have

- been determined. Nor do most of the documents explain how the fiscal targets relate to the rest of the program, in particular to assumptions about recovery in private sector demand and short-term growth prospects” (IMF-IEO, 2003: 4).
- 11 In the Russian Federation and Norway the accumulation of financial resources from hydrocarbons in public funds greatly exceeds what may be needed for smoothing public expenditure, and actually constitutes a strategic asset for obtaining financial revenues to be used in the long term. In other cases, extra revenues from exports have been earmarked for the early repayment of public debts (Ecuador), financing development projects or constituting a fund for “future generations” (Chad). In all these cases, containing public expenditure in times of bonanza is intended to stabilize economic growth in the medium term and to avoid the appearance of fiscal deficits in the future, as it may be difficult to reduce fiscal expenditure when windfall revenues disappear. However, these rules may not be tenable
- if remaining government income is insufficient for coping with more urgent needs, as appeared to be the case in Chad and Ecuador.
- 12 Art. VI (Capital Transfers) Section 3 (Controls of Capital Transfers) states “Members may exercise such controls as are necessary to regulate international capital movements ...”.
- 13 For a comprehensive survey of capital controls, see also Neely, 1999.
- 14 An alternative proposal, put forward in Chile when capital inflows started gaining momentum in the early 1990s, was to compensate for the ensuing increase in private demand by reducing government expenditure. The introduction of the “encaje” allowed the government to sustain, and even increase slightly, social expenditures while avoiding an excessive increase in domestic demand, thus gaining autonomy in fiscal policy.
- 15 For more details on non-monetary measures to curb inflation, see Flassbeck et al., 2005.

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