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OVERVIEW

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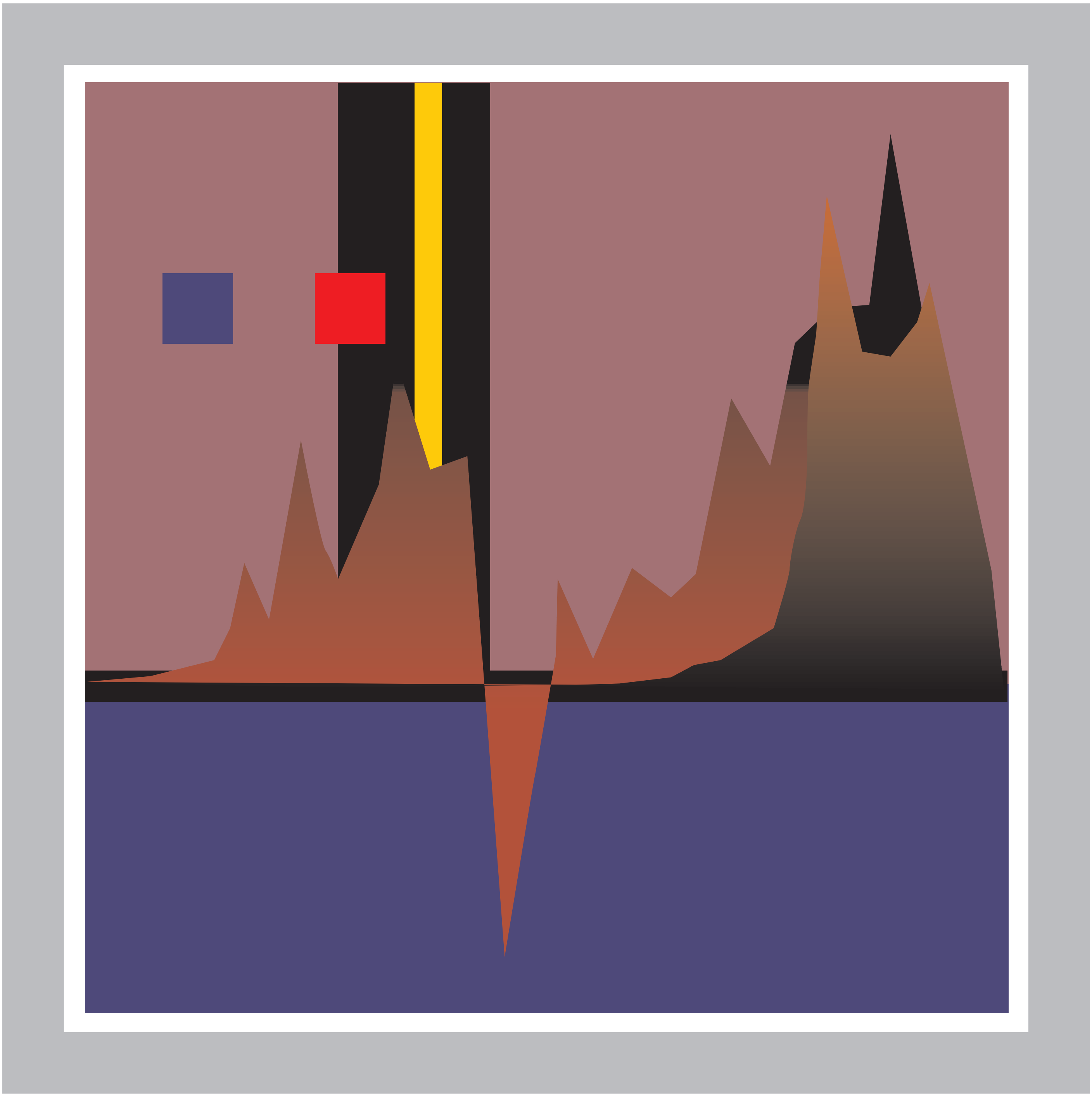

OVERVIEW

Since the UNCTAD secretariat made its first assessment of globalization, in TDR 1997, conditions in the developing world have deteriorated drastically. The few bright spots, mainly in East Asia and Latin America, which could light the way for others to a better future have been dimmed, and the much-hoped-for turning point in Africa has not been reached. The predicted gains to developing countries from the Uruguay Round have proved to be exaggerated and, as feared, international capital movements have been particularly disruptive. Poverty and unemployment are again on the rise in developing countries which had struggled for many years to combat them. Income and welfare gaps between and within countries have widened further.

As the twentieth century comes to an end, the world economy is deeply divided and unstable. The failure to achieve faster growth that could narrow the gap between the rich and the poor must be regarded as a defeat for the entire international community. It also raises important questions about the present approach to development issues.

Asymmetries and biases in the global system against the poor and underprivileged persist unchecked. Leaving global economic integration to markets has not helped, and that should hardly come as a surprise. Unbridled competition, particularly among unequals, has never, by itself, delivered faster growth and shared prosperity even in today's developed countries, and it has at times been destructive. There is no reason to expect a different outcome in a globalizing world.

Bold leadership, purposeful cooperation and compassion are essential ingredients if today's fragmented global economy is to give way to a century of peace and prosperity. In their absence, and if history is any guide, all will suffer.

The world economy: fragile recovery with downside risks

While the developed world suffered little from the Asian financial crisis that broke out in 1997, and even derived some benefits from it, the impact on the rest of the world has been dramatic. Virtually all developing countries and transition economies were affected. It played havoc in East Asia and Russia throughout 1998, set back the progress achieved in Latin America, and in the most seriously affected countries wiped out the fruits of decades of economic growth and poverty reduction. In its wake, growth in the developing world slowed from almost 6 per cent in 1996 to under 2 per cent in 1998, and for the first time in 10 years it was less than in industrial countries. In the transition economies the impact of the Russian crisis was to plunge the region as a whole into recession following positive growth in 1997 for the first time since the beginning of the transition process.

The two largest developing countries, China and India, have been striking exceptions in this otherwise bleak landscape. It is notable that both of these countries had resisted the temptation to pursue premature trade liberalization and rapid integration into the global financial system.

Crisis in developing countries has had serious repercussions for international trade. The substantial swing in trade balances in the Asian countries through massive import cuts has played an important role in the re-emergence of major trade imbalances in the world economy not experienced since the 1980s. It has also been a main factor in the slowdown of world trade, which suffered in value terms its strongest decline since 1982, and in the dramatic and widespread fall in commodity prices. As a result, for the first time in 50 years, the share of primary products in world trade fell below 20 per cent. This, together with the appreciation of the dollar in 1997 and most of 1998, brought about a decline in the dollar value of export earnings of developing countries for the first time since 1991.

A fall by one third in world oil prices was responsible for an estimated 86 per cent of the overall decline in the value of world trade. OPEC export revenues plummeted by over $50 billion in 1998, and oil exporters as a whole lost more than 6 per cent of their GNP. Non-oil developing countries, too, suffered terms-of-trade declines and income losses. At 12 per cent, the drop in non-oil commodity prices was unprecedented since the mid-1970s. In Latin America, declines in export prices resulted in a loss of over $10 billion in foreign-exchange earnings, and in sub-Saharan Africa the losses reached almost 2.5 per cent of GDP.

Industrial countries, by contrast, gained from the unprecedented collapse in commodity prices and cheaper manufactured imports from countries that had suffered currency devaluations. Gain from cheaper imports of oil alone amounted to some $60 billion, exceeding total official development assistance in 1998. The improvement in their terms of trade greatly helped to maintain income levels and reduce inflation.

Similarly, developed countries suffered little from the sharp declines in asset prices or increases in risk premia in global capital markets that accompanied drastically reduced capital inflows into emerging markets, especially in the months immediately following the Russian crisis in August 1998. Nor were they greatly affected by the Brazilian crisis of January 1999. On the contrary, the flight to safety which followed financial turmoil in developing and transition economies has helped to boost stock markets in the North and stimulate consumption, notably in the United States, which has enjoyed an unprecedented eighth year of expansion. Private consumption in the United States rose by over $400 billion from the second quarter of 1997 to the end of 1998, more than twice the total annual income of sub-Saharan Africa.

Prospects for the global economy have improved since the beginning of the year. The fear of contagion from the Russian crisis has proved exaggerated and the adverse impact of the Brazilian crisis has so far been confined to the region. However, as concern over a possible global recession has receded, fear has given way to complacency. This has been encouraged by a modest return of capital inflows to most emerging markets and indications that prices of certain commodities, particularly petroleum, are turning up, thanks largely to supply cuts rather than demand expansion.

On current trends the overall performance of the world economy in 1999 is unlikely to differ significantly from the previous year, although different regions are moving in different directions. Among the industrial countries growth in the United States economy is likely to moderate. While some improvement may be expected in Japan, a sustained recovery is not yet in sight. With strong recovery continuing to elude the European Union, GDP growth in developed countries is unlikely to exceed the disappointing rate of 1998.

In developing countries, excluding China, growth will be below that of population and lower than in industrial countries. The slowdown in China will continue, while contraction is expected in Latin America and growth will remain weak in Africa. Recovery in some of the crisis-stricken countries in East Asia will only be sufficient to make up for losses elsewhere. Consequently, no major improvement in the overall performance of developing countries can be expected.

Neither a return to stability in the Asian economies nor the apparent confinement of the impact of the Brazilian crisis to neighbouring countries should hide the immediate downside risks for the world economy. Stabilization of conditions in many emerging markets, including Brazil and Russia, does not mean that the underlying structural problems, including fiscal fragility, have disappeared. Yield spreads continue to be high and while private capital inflows into developing countries are expected to recover somewhat in the year 2000, they will remain far below pre-crisis levels. Even so, there is potential instability inherent in the dependence of so many developing countries on foreign capital inflows that are so volatile.

In Latin America, combining foreign and fiscal balance with an acceptable growth rate still eludes many countries. Indeed, despite poor growth performance several of the major economies, notably Argentina and Brazil, are running current-account deficits above the critical level of 4 per cent of GDP. External indebtedness and dependence on foreign capital flows are again on the increase and any loss of confidence could spark off a reversal of capital flows that could make debt-servicing problematic. The region remains vulnerable to hikes in United States interest rates.

In Asia, the speed and sustainability of the current recoveries are uncertain, and problems may emerge elsewhere in the region, notably in China with respect to maintenance of the exchange rate. The crisis has led to a slackening of exports and domestic private demand in that country, causing delay in restructuring of the financial system and of state enterprises. So far, adverse conditions in the external sector have been offset by heavy public expenditure programmes, but if the present exchange rate cannot be maintained there is a risk of currency realignments throughout the region which would jeopardize the nascent recovery in the crisis-stricken countries.

A sustained recovery in Asia and Latin America will, of necessity, be export-based and thus dependent on the pace of economic activity in industrial countries. Although rapid growth of demand in the United States has been crucial in preventing global recession, it cannot do so indefinitely. Continued rapid expansion would certainly bring about further monetary tightening, not only creating difficulties for developing countries but also putting European recovery in jeopardy. It would also lead to higher trade deficits and mounting protectionist pressures. Since domestic demand growth is increasingly dependent on stock prices and borrowing by households and firms, some slowing of the expansion must eventually take place. Will it be a “soft landing” or will growth decelerate sharply, thereby risking another equity market break and further weakening the momentum of world growth?

Recovery in Japan continues to depend on fiscal stimuli. But because of widespread excess capacity and weak balance sheets in the private sector, government outlays do not generate strong secondary expenditure effects. Once the immediate impact is absorbed, the economy tends to slither. The fiscal package announced for the autumn of 1999 thus seems to be essential if the double dip experienced in 1996 is to be avoided. Growth in the longer term will depend on structural reform.

Relatively little stimulus to world growth can be expected in the near future from the European Union, where 11 of its members face internal challenges with the adoption of a single currency. Widely heralded as a competitor to the dollar, the euro has depreciated by over 10 per cent since its introduction at the beginning of the year, giving a much-needed boost to European competitiveness but raising questions of credibility. The European Central Bank is also confronted with the dilemma of pursuing a monetary policy for economies that still exhibit considerable variation in growth rates. While many of the difficulties of the euro may be due to the cyclical asymmetry between the United States and the EU, its strength over the longer term may well depend on whether the EU countries can undertake an industrial restructuring similar to that of the United States in the early 1990s.

Should recovery in the EU and Japan be delayed for any reason, the stimulus to global growth would have to come from developing countries. However, confronted with external financial difficulties and domestic restructuring, those countries have little room to use traditional fiscal policy measures for fear of losing the confidence of capital markets, and monetary policy is constrained by the foreign-exchange market. Given the limited scope in developing countries to pursue counter-cyclical macroeconomic policies, an alternative would be the direct injection of liquidity into those countries through official channels to raise demand, imports and growth. This cannot be adequately done by multilateral financial institutions, whose resources have been drained by financial rescue operations and whose access to new resources has been curtailed by increased political resistance to such bailouts.

By contrast, Japan and EU are able to play an important role in providing direct liquidity injections by recycling part of their large current-account surpluses. Since developing countries have a higher propensity to consume and import, such schemes could prove to be superior, in their effect on global growth, to domestic fiscal expansion in the surplus countries themselves. The Miyazawa Plan offers one such model, but other means of directly increasing liquidity should also be explored. One possibility would be to remove the debt overhang of highly indebted poor countries through an immediate write-off of their unpayable official debt while extending the range of eligible countries under the HIPC Debt Initiative. Payments support to developing countries and the transition economies could also be provided through substantial SDR allocations. There are already suggestions to use such allocations on a reversible basis in order to provide liquidity to emerging markets facing a threat of financial contagion. No less valid is the case for similar action to provide additional current-account financing, particularly since much greater reserves are now needed as a protection against possible currency instability.

Trade, external financing and economic growth in developing countries

Liberalization, external constraints and growth

In recent years developing countries have striven hard, and often at considerable cost, to integrate more closely into the world economy. But, in the face of deep-seated imbalances in economic power and systemic biases in the international trading and financial systems, their expectations of the gains from such integration in terms of faster growth, greater employment opportunities and reduced levels of poverty have been disappointed. A clear example is the extravagant predictions made regarding the gains they could reap from the Uruguay Round. By contrast, the downside risks have proved far greater than was generally expected, as recently demonstrated by the experience of East Asia and Latin America. The humbling of the Asian tigers since 1997 has revealed the vulnerability of even the strongest developing economies to the powerful forces unleashed by globalization. Indeed, the twentieth century is closing on a note of crisis and a growing sense of unease about the policy advice that was proffered in the past decade.

Much of that advice was fashioned in response to the debt crisis of the early 1980s, when a reorientation of policies in the industrial countries led to considerable macroeconomic distress in many developing countries and a sharp fall in their growth rates. Severe balance-of-payments crises revealed the extent to which rapid growth in the South had come to depend on steadily rising export earnings and capital inflows and just how disruptive an interruption to these sources of foreign exchange could be. For many, the crisis was final proof that inward-oriented growth strategies and interventionist policies could not extract developing countries from the mire of poverty and underdevelopment. Thus, in the second half of the decade, a powerful consensus was forged around "getting prices right". Close integration with the world economy through rapid liberalization of trade, finance and investment was believed to be the recipe for preventing setbacks to development caused by recurrent payments crises. Trade liberalization would ensure the best allocation of resources according to comparative advantage, securing the export revenues needed to import key ingredients of faster growth. Financial liberalization would attract foreign capital seeking high returns in these capital-scarce countries, allowing them to invest more than they save without running into a payments constraint. A bigger flow of foreign direct investment would further accelerate growth not only by supplementing domestic resources for capital accumulation, but also through transfer of technology and organizational skills.

Fast integration into the world economy thus seemed to promise an alternative to stop-go growth and development through export expansion and inflows of private foreign capital, providing the inspiration for widespread reform and encouraging "big bang" liberalization. Indeed, the growth of world trade and, perhaps even more decisively, the recovery of financial flows to developing countries in the 1990s were taken as confirmation that a new era of prosperity was beginning to unfold and that it would include a growing number of developing countries.

However, few attempts have been made to examine what rapid integration has actually meant for developing countries. The analysis in this *Report* shows that the empirical record has been at odds with the promises. Inevitably, the discussion involves "nuts and bolts" economics of a technical nature, but the conclusion is a simple and striking one. It is that, after more than a decade of liberal reforms in developing countries, their payments disorders, which had earlier ushered in a rethinking of policies, remain as acute as ever, and their economies depend even more on external financial resources for the achievement of growth rates sufficient to tackle the deep-rooted problems of poverty and underdevelopment:

- Growth in developing countries has generally recovered in the 1990s from the levels of the 1980s, but it has remained well below the average of 5.7 per cent achieved during the 1970s. This recovery has been accompanied by a significant worsening of external deficits. For developing countries as a whole (excluding China), the average trade deficit in the 1990s is higher than in the 1970s by almost 3 percentage points of GDP, while the average growth rate is lower by 2 per cent per annum.

- Low prices of oil are only part of the story. In the non-oil-exporting developing countries the trade deficit in the 1990s stands at approximately the same proportion of GDP as in the 1970s, while the average growth rate is lower by 2 per cent per annum.

- The pattern is broadly similar in all developing regions. In Latin America the average growth rate is lower by 3 per cent per annum in the 1990s than in the 1970s, while trade deficits as a proportion of GDP are much the same. In sub-Saharan Africa growth fell, but deficits rose. The Asian countries managed to grow faster in the 1980s, while reducing their payments deficits, but in the 1990s they have run greater deficits without achieving faster growth.

- In almost half of the developing countries examined, which include exporters not only of commodities but also of manufactures, the trend is one of widening trade deficits, with falling or stagnant growth rates. Where trade balances have improved, there has generally been a slowdown in economic growth and imports. Among the countries which succeeded in achieving faster growth, the majority experienced a deterioration in their trade balances, financed by inflows of private capital. However, such inflows could not always be sustained and eventually led to currency crises, economic contraction and massive import cuts. Only a very small number of countries, notably China and Chile, have been able to buck this general trend by combining faster growth with improved trade performance.

The reasons why trade deficits have been increasing faster than income in developing countries are undoubtedly complex. However, the evidence shows that a combination of declining terms of trade, slow growth in industrial countries and "big bang" liberalization of trade and of the capital account in developing countries has been a decisive factor.

For developing countries as a whole the terms of trade fell by more than 5 per cent per annum during the 1980s. The more favourable trend around the mid-1990s due to a recovery in oil and non-oil commodity prices has been more than offset by large losses since 1996, when these prices declined by about 16 per cent and 34 per cent, respectively. For non-oil developing countries, the decline in the terms of trade has been steady, at about 1.5 per cent per annum, since the early 1980s. Terms-of-trade losses are no longer confined to commodity exporters. Many manufactures exported by developing countries are now beginning to behave more like primary commodities as a growing number of countries simultaneously attempt to raise their exports in the relatively stagnant and protected markets of industrial countries. For example, the prices of manufactures exported by developing countries fell relative to those exported by the European Union by 2.2 per cent per annum from 1979 to 1994.

The slower growth in industrial countries during the past two decades than in the 1970s may have added to trade deficits of developing countries perhaps by as much as 1 per cent of GDP. Rapid trade liberalization in the latter countries has further added to their deficits; it led to a sharp increase in their import propensity, but exports failed to keep pace, particularly where liberalization was a response to the failure to establish competitive industries behind high barriers. With the notable exception of China, liberalization has resulted in a general widening of the gap between the annual growth of imports and exports in the 1990s, but the impact was particularly severe in Latin America, where the gap averaged about 4 percentage points.

Liberalization of capital flows, often prompted by the need to finance growing external deficits, has actually made matters worse. It has led to currency appreciations and instability, thereby undermining trade performance. Despite greater exposure to foreign competition, there have been serious shortcomings in exchange-rate management, even compared to the interventionist regimes of the 1970s and 1980s. An examination of exchange-rate movements in 58 developing countries shows that, after persistent appreciations, 8 of them resorted to real devaluations in the 1970s of 25 per cent or more but that there were as many as 24 in the 1980s. From 1990 until 1997, before the more recent turmoils in East Asia or Latin America, 19 countries experienced comparable reversals.

Private capital flows: solution or problem?

With today's globalized financial markets, access to foreign private capital is generally expected to greatly alleviate the external constraint on growth. Certainly, the 1990s have witnessed a rapid expansion of private capital inflows into developing countries, registering a sevenfold increase over the average for the 1970s. Portfolio flows and foreign direct investment (FDI) have shown the strongest growth, accounting for more than two thirds of total private inflows.

While such figures have received increased attention in the financial press, and seem to have had a mesmerizing effect on many policy makers in the South, a sense of proportion is called for:

- The upsurge in the 1990s represents no more than a return to trend after the blighted years of the 1980s. The annual capital inflow in the 1990s was around 5 per cent of GNP, which was roughly the level prevailing in 1975–1982. If China is excluded, the ratio is actually lower than in the earlier period by one percentage point.

- Not all trends are rising. Official development assistance has steadily declined throughout the present decade, falling in real terms in 1998 to its lowest level for many years. The share of official financing in total capital inflows fell from over 50 per cent in the 1980s to 20 per cent in the 1990s.

- As official financing took a back seat, capital inflows have increasingly been concentrated in a small group of 20 or so emerging markets which received over 90 per cent of total inflows of capital in the 1990s, compared to some 50 per cent before the outbreak of the debt crisis. As regards FDI, China, Brazil and Mexico together accounted for almost one half of the total inflow; their per capita inflow, in the range of $20–$80, and an inflow of as much as $223 per capita in Malaysia, stand in stark contrast to under $5 in many countries in sub-Saharan Africa.

- An important part of private capital inflows, notably liquid capital seeking arbitrage profits, is highly unstable and hence constitutes an unreliable source of development finance. This is particularly true for short-term loans and portfolio equity, which together reached $100 billion by the middle of the decade (about 40 per cent of all private inflows into developing countries) but fell to a mere $15 billion after the financial crises in East Asia and Russia.

Moreover, a growing proportion of net private capital inflows is absorbed by activities which add little to productive capacity in those emerging markets fortunate enough to receive them: of every dollar brought in by non-residents 24 cents were taken out by residents, compared to 14 cents in the 1980s. No less disturbing is that more than 20 cents of every dollar of net capital inflow are put aside for the accumulation of foreign-exchange reserves, notwithstanding policy reforms designed to ensure greater exchange-rate flexibility and increased access to global capital markets. Developing countries have increasingly been advised to cover their short-term liabilities by reserves as a safeguard against speculative attacks on the currency and reversal of capital flows; the increase in reserves from 1990 to 1998 amounted to a staggering 60 per cent of the increase in their import bill during the same period.

The cost has been high, since reserves are borrowed at much higher rates than they can earn in international financial markets. The net cumulative cost over 1990–1997 may have been as much as $50 billion. Moreover, short-term capital inflows have a high rate of leakage. In the 1990s, for every dollar of short-term capital brought in by non-residents, 56 cents were taken out by residents for investment in short-term assets abroad. Thus, such capital flows provide little for current-account financing, while provoking significant instability. There is consequently an urgent need to reconsider the case for their liberalization.

Even the strong growth of FDI flows to developing countries in the 1990s should not be allowed to hide the simple fact that it largely reflects mergers and acquisitions (rather than greenfield investment), which accounted for well over half of the total FDI inflow in 1992–1997 and for almost three quarters if China is excluded. Much of this merger activity was in service sectors, and has the potential to add to payments difficulties. Attempts to meet foreign-exchange deficits of TNC-related activities by encouraging new inflows of the same kind would be self-defeating. In any case, it is not clear whether the recent momentum of FDI attracted by acquisition of existing assets can be maintained over the longer term, since there are limits to the stock of assets for sale, particularly in the public sector.

Although an important part of the capital inflow into developing countries in the present decade has allegedly been "non-debt-creating", external indebtedness is again on the rise, in both absolute and relative terms. In Latin America, for instance, for the first time in the 1990s, the ratio of debt to exports increased in 1998, reaching 203 per cent, from 191 per cent in 1997, and there was likewise an increase in the ratio of interest payments to exports. Higher interest payments add to the difficulties caused by widening trade deficits and run the risk of incurring an unsustainable debt burden. Developing countries should not heed the doctrine, popularized by the more exuberant exponents of liberal orthodoxy, that rising current-account deficits and external indebtedness generated by the private (as opposed to the public) sector are immune to the dangers that proved so destructive in the early 1980s.

In any case, on recent trends, the level and composition of net capital flows received by most developing countries are inadequate to meet their existing external financing requirements. They fall far short of those which would be needed to achieve a target growth of 6 per cent. Even under relatively optimistic assumptions regarding growth in industrial countries and the terms of trade, the external financing needs of developing countries can be estimated to exceed recent net capital inflows by more than 40 per cent. The gap would be greater if growth in industrial countries remains sluggish and the terms of trade of developing countries continue to deteriorate.

Rethinking policies: market access, not hot money

With liberal trading regimes now in place throughout much of the developing world, growth sucks in a greater volume of imports than in the past. Attempts to close the payments gap through increased exports to developed countries run up against sluggish markets, adverse movements in the terms of trade and protectionism. As a result, maintaining growth momentum increasingly relies on attracting foreign capital, of any kind. Dependence on hot money has thus become the unstable pillar of economic growth and development in many countries. This situation contrasts with the post-war experience of liberalization in industrial countries, where the process was a gradual one and was underpinned by exceptionally strong growth.

The time has thus come for a rethinking of policies and responsibilities, which should, and indeed must, involve those of the world's richest countries as well as of the developing ones. The international community must face up to the pronounced external constraints to development and the need for exports rather than unstable capital flows to underpin a return to rapid and sustained growth in the third world.

Achieving an increase in exports requires growth in world demand, while additional foreign borrowing makes sense only if the higher export earnings are sufficient to finance the additional debt service. Thus, liberalization as a successful growth strategy in an interdependent global economy relies crucially on exports, which in turn are highly dependent on growth in industrial countries and greater access of developing countries to their markets. For their part, developing countries must promote efficient and competitive industries.

It is now time to take a long, hard look at the international trading system and identify the shortcomings of the Uruguay Round Agreements and their implementation, in order to establish the appropriate basis for new multilateral negotiations or of a "development round". Attention needs to be focused on market access. Tariff levels and the frequency of tariff peaks are still high in many areas of export interest to developing countries. For example, in agriculture excessively high rates are applied in developed countries mainly to products that offer a potential for export diversification in the South. Moreover, the subsidization of agricultural output in the North not only shuts out imports from developing countries, but also leads to unfair competition in the latter's own markets. The annual cost of support for agriculture in industrial countries in 1996–1998 was double the level of agricultural exports from developing countries during those three years. Although EU producers are among the world's highest-cost producers of dairy products, they have a 50 per cent share of the world market.

The panorama of protectionism is no better for industrial products. Footwear, clothing and textiles are well-known cases. But tariff peaks are also common in other low-technology and resource-based industries, as well as for high-technology products which involve unskilled labour in the production of components. Moreover, the threat of market penetration by southern producers is prompting new forms of protectionism within the framework of the various WTO Agreements. The abuse of anti-dumping procedures and health and safety standards against successful exporters in the South is causing major concern and there are also signs that the provisions of the Agreements are not always being properly adhered to; for example, voluntary export restraints continue to be applied.

There is strong evidence that in many product markets that are protected in the North, producers in developing countries have a competitive advantage or are able to acquire one. The potential for large overall export gains is underscored by this year's *Report*. It is estimated that an extra $700 billion of annual export earnings could be achieved in a relatively short time in a number of low-technology and resource-based industries. Agricultural exports could add considerably to this figure. All-in-all, the increase in annual foreign-exchange earnings could be at least four times the annual private foreign capital inflow in the 1990s. Moreover, unlike a large part of such flows, the resources would be devoted to productive activities, with beneficial effects on employment.

More flexibility should also be granted to developing countries in the design and implementation of policies. Building competitive industries holds the key to overcoming the external constraint not only by boosting export capacity but also by reducing the import content of growth. The scope for promoting exports through direct support has been reduced since the pioneers of export-led growth made their successful entry into world markets. However, the considerable financial resources employed by the world's richest countries to support their mature producers provides sufficient grounds to retain the infant-industry concept as an integral part of trade-policy discussion. Moreover, the success of the East Asian and other fast-growing developing economies shows that an export push often followed the build-up of domestic production capacity that replaced imports.

Advice aimed at encouraging the full use of what is still possible under the existing rules of the trading system needs to be strengthened, and further restrictions should be avoided. It is also important to secure consistency between policies regarding the current and the capital account. For instance, in view of the changing nature of the external vulnerability of developing countries, in particular to the volatility of capital flows, the conventional criteria of legitimate action need to be reviewed. Criteria based on imports or current-account deficits can no longer provide an appropriate basis for assessing reserve adequacy and hence the legitimacy of measures to safeguard the balance of payments in the context of WTO provisions. In some areas of trade policy, where review processes are, or about to get, under way, the full impact on the competitiveness of developing countries of limiting the policy options open to them needs to be reconsidered, in particular with respect to subsidies, intellectual property rights and trade-related investment measures. Special and differential treatment for developing countries, as a means of guaranteeing them adequate policy flexibility, should be made part of the contractual obligations of the rule-based system.

Developing countries need to improve the management of their exchange rates if they are to benefit from greater integration into the trading system. The advice they have received in recent years has been at best confusing and at worst misleading. Under free capital mobility, no exchange-rate regime can guarantee stable and competitive rates. Contrary to some perceptions, countries with floating rates are no less vulnerable to financial crises than those with pegged or fixed ones. Differences among pegged, floating and fixed regimes lie not so much in their capacity to prevent damage to the real economy as in the way damage is inflicted in the first place. There now appears to be a growing consensus that developing countries should target real exchange rates in combination with the control and regulation of destabilizing capital flows. This offers a viable alternative to free floating or to ceding completely monetary authority to a foreign Central Bank. Successful examples of control over inflows and outflows abound, from Chile to China, India and Malaysia, and provide a rich arsenal of tools for better management of the capital account and exchange rates.

It is essential that the autonomy of developing countries in managing capital flows and choosing whatever capital-account regime they deem appropriate should not be constrained by international agreements on capital-account convertibility or trade in financial services. Indeed, a basic objective for countries at all levels of development should be to roll back the control that financial capital has established over trade, industry and employment. It should also be recognized that private capital markets have not always been successful in replacing official development finance. Reform of the global financial architecture should focus on these issues, and include a greater role for official financing, recognize the rights as well as the obligations of debtors and provide for full debt relief for the poorest developing countries.

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When all is said and done, progress on access to northern markets remains key to overcoming the payments constraints facing developing countries. For this to happen, industrial countries, particularly Japan and the EU, must grow more rapidly. With expansionary macroeconomic policies and targeted structural measures, they can do it. But Governments in the North should also work harder to convince a sometimes sceptical public that there are direct benefits, in terms of more jobs and rising incomes, from expanding trade with the South. They must also recognize that a more stable international financial system free from hot money and recurrent crises in emerging markets is in their longer-term interests.

A rising tide will lift all boats. However, this approach is not easy. It requires effective leadership and a spirit of cooperation. For the sake of future generations, the sooner these are in place the better.

Rubens Ricupero
Secretary-General of UNCTAD