

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**GLOBALIZATION AND THE SOUTH:  
SOME CRITICAL ISSUES**

*Martin Khor*

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**DISCUSSION PAPERS**

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# **GLOBALIZATION AND THE SOUTH: SOME CRITICAL ISSUES**

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*This paper examines the implications of some of the main features of the globalization process for developing countries. It also makes several proposals for developing countries in considering national-level policies to face the globalization challenge, as well as coordination among developing countries in facing negotiations or making proposals at the international level.*

*While there are many aspects to globalization, among the most important is the recent globalization of national policy-making not only through the normal spread of orthodox theories but more importantly through international agencies, such as the Bretton Woods institutions and the World Trade Organization, through which the North has leverage over the South.*

*The paper examines the liberalization of trade, finance and investment as well as policy implications and choices in each of these categories. It is argued that, while there are some advantages to an open regime for developing countries, the impact of openness depends on a country's level of development and preparedness to take on the challenges of subjecting local production units to foreign competition, of being able to break into world markets, and of weathering the volatility and fickleness of private capital flows and their propensity for lending recipient countries into a debt trap.*

*It is therefore imperative that developing countries be given the possibility to have an adequate range of options, of when, how and to what extent to open their economies. For them to maintain the choice of flexibility in policy options, developing countries have to collectively press their case in international forums and institutions where decisions on the global economy are made. Failure in doing so would mean that developing countries will continue to be subjected to international and national policies that are unsuitable to their development, and that more than ever close off their development prospects and options.*

## **Introduction**

Globalization has become the defining process of the present age. While the opportunities and benefits of this process have been stressed by its proponents and supporters, recently there has been increasing disillusionment among many policy makers in the South, analysts and academics, as well as the community of non-governmental organizations (NGOs) in both the South and the North. The failure of the Seattle Ministerial Conference of the World Trade Organization in December 1999 is a signal of this disillusionment.

The reasons for the changing perception of and attitude towards globalization are many. Among the important factors are the lack of tangible benefits to most developing countries from

opening their economies, despite the well-publicized claims of export and income gains; the economic losses and social dislocation that are being caused to many developing countries by rapid financial and trade liberalization; the growing inequalities of wealth and opportunities arising from globalization; and the perception that environmental, social and cultural problems have been made worse by the workings of the global free market economy.

This paper examines the nature of economic globalization, some of its key aspects (financial, trade and investment liberalization), and recent developments and the implications for the South. It also provides proposals and suggestions on what could be done to reduce the negative aspects of globalization, and in particular what the countries of the South can do at the national and international levels to reduce the risks involved in (and better manage) the interface between the national economy and the global economy.

While globalization is facilitated and influenced by technological developments such as modern information and communications technology, the paper argues that the process is mainly driven and enabled by policy choices at the global and national levels that in recent years have led to the rapid liberalization of finance, trade and investment. Although developing countries have been very much a part of this process of rapid integration, the decision-making processes in the making of these policy choices have in the main been dominated by governments of the developed countries and by international institutions that are mainly under their control or influence.

The latest round of financial crises, starting with what happened in East Asia in 1997, the widespread doubts over the appropriateness of the standard policy responses to the crisis by international financial institutions, and the failure of the WTO's Seattle meeting, have catalysed a serious rethinking of the orthodox policies and approach to globalization and liberalization.

The rethinking exercise, which was most recently given a platform at UNCTAD's Tenth Conference in Bangkok in February 2000, provides an opportunity for the South to take a more active role in reviewing recent developments in the global economy, their impact on developing countries, and the role these countries can play in reversing the negative aspects, while taking positive measures individually and collectively in pursuing more appropriate policy options and negotiating strategies (UNCTAD, 2000).

This paper is organized into five chapters, following a brief introduction. Chapter I summarizes the main features of globalization, including economic liberalization, the globalization of policy-making, and the unbalanced nature and effects of the process. The next three chapters then examine the major aspects of economic globalization. Chapter II discusses trade liberalization, some recent findings on its effects, and recent developments in the WTO. Chapter III discusses financial liberalization, including the recent round of financial crises, the risks of volatile short-term capital flows, and deficiencies in the present financial system. Chapter IV discusses investment liberalization, the nature of foreign direct investment (FDI) and the implications of the proposals and moves for international agreements on investment. In Chapters I, II and III, lessons to be learnt from the experiences of liberalization and proposals for improving the situation are provided. Finally, chapter V draws some general conclusions and provides some general proposals.

## I. THE GLOBALIZATION PROCESS

### A. The liberalization of trade, finance and investment

Economic globalization is not a new process, for in the past five centuries firms in the economically advanced countries have increasingly extended their outreach through trade and production activities (intensified in the colonial period) to territories all over the world. However, in the past two to three decades, economic globalization has accelerated as a result of various factors, such as technological developments but especially the policies of liberalization that have swept across the world.

The most important aspects of economic globalization are the breaking down of national economic barriers; the international spread of trade, financial and production activities and the growing power of transnational corporations and international financial institutions in these processes. While economic globalization is a very uneven process, with increased trade and investment being focused in a few countries, almost all countries are greatly affected by this process. For example, a low-income country may account for only a minuscule part of world trade, but changes in demand or prices of its export commodities or a policy of rapidly reducing its import duties can have a major economic and social effect on that country. That country may have a marginal role in world trade, but world trade has a major effect on it, perhaps a far larger effect than it has on some of the developed economies.

The external liberalization of national economies involves breaking down of national barriers to economic activities, resulting in greater openness and integration of countries in the world markets. In most countries, national barriers are being removed in the area of finance and financial markets, trade and direct foreign investment.

Of the three aspects of liberalization (finance, trade and investment), the process of financial liberalization has been the most pronounced. There has been progressive and extensive liberalization of controls on financial flows and markets. The demise of the Bretton Woods system in 1972–1973 opened up an international trade in foreign exchange that has expanded at spectacular rates. The volume traded in the world foreign exchange market has grown from a daily average of \$15 billion in 1973 to over \$900 billion in 1992 and now far exceeds \$1,000 billion. Much of this transaction is speculative in nature, as it is estimated that only a small portion (less than 2 per cent) of the foreign exchange traded is used for trade payments.

Due to the interconnectedness of financial markets and systems and the vast amounts of financial flows, there is a general and increasing concern about the fragility and vulnerability of the system, and the risk of breakdown in some critical parts or in the general system itself as a fault developing in one part of the world or in the system can have widespread repercussions.

The concerns about a possible global financial crisis have been heightened by the East Asian financial crisis that began in the second half of 1997 and which spread to Russia, Brazil and other countries, causing the worst financial turmoil and economic recession in the post World War II period.



Trade liberalization has also gradually increased, but not at such a spectacular pace as with finance. World exports rose from \$61 billion in 1950 to \$315 billion in 1970 and \$3,447 billion in 1990. The share of world exports in world GDP rose from about 6 per cent in 1950 to 12 per cent in 1973 and 16 per cent in 1992 (Nayyar, 1997). The increased role of trade has been accompanied by the reduction in tariff barriers generally in both developed and developing countries, due partly to autonomous policies and partly to the series of multilateral trade Rounds under GATT. However, high tariffs still persist in developed countries in sectors such as agriculture and textiles and for selected manufactured products, which are areas in which developing countries have a comparative advantage. Moreover, there has been an increased use of non-tariff barriers which have affected the access of developing countries to the markets of developed countries.

There has also been a steady growth in liberalization of FDI, although again on a smaller scale than in international financial flows. Much of FDI and its increase are due to flows among the advanced countries. However, since the early 1990s, FDI flows to developing countries have risen relatively, averaging 32 per cent in 1991–1995 compared with 17 per cent in 1981–1990. This coincides with the recent liberalization of foreign investment policies in most developing countries. However, much of this FDI has centred in only a few developing countries. LDCs in particular are receiving only very small FDI flows, despite having liberalized their policies. Thus, FDI is insignificant as a source of external finance to most developing countries, and is likely to remain so in the next several years.

A major feature of globalization is the growing concentration and monopolization of economic resources and power by transnational corporations and by global financial firms and funds. This process has been termed “transnationalization”, in which fewer and fewer transnational corporations are gaining a large and rapidly increasing proportion of world economic resources, production and market shares. Where a multinational company used to dominate the market of a single product, a big transnational company now typically produces or trades in an increasing multitude of products, services and sectors. Through mergers and acquisitions, fewer and fewer of these TNCs now control a larger and larger share of the global market, whether in commodities, manufactures or services. The top 200 global corporations accounted for \$3,046 billion of sales in 1982, equivalent to 24 per cent of world GDP (\$12,600 billion) that year. By 1992, their sales had reached \$5,862 billion, and their equivalent value to world GDP (\$21,900 billion) had risen to 26.8 per cent.

## **B. The globalization of policy-making**

Perhaps the most important and unique feature of the current globalization process is the “globalization” of national policies and policy-making mechanism. National policies (including in economic, social, cultural and technological areas) that until recently were under the jurisdiction of States and people within a country have increasingly come under the influence of international agencies and processes or by big private corporations and economic/financial players. This has led to the erosion of national sovereignty and narrowed the ability of governments and people to make choices from options in economic, social and cultural policies.

Most developing countries have seen their independent policy-making capacity eroded, and have to adopt policies made by other entities, which may on balance be detrimental to the countries

concerned. The developed countries, where the major economic players reside, and which also control the processes and policies of international economic agencies, are better able to maintain control over their own national policies as well as determine the policies and practices of international institutions and the global system. However, it is also true that the large corporations have taken over a large part of decision-making even in the developed countries, at the expense of the power of the State or political and social leaders.

Part of the erosion of national policy-making capacity is due to the liberalization of markets and developments in technology. For example, the free flow of capital, the large sums involved, and the unchecked power of big players and speculators, have made it difficult for countries to control the level of their currency and the flows of money in and out of the country. Transnational companies and financial institutions control such huge resources, more than what many (or most) governments are able to marshal, and thus are able to have great policy influence in many countries. Certain technological developments make it difficult or virtually impossible to formulate policy. For example, the establishment of satellite TV and the availability of small receivers, and the spread of the use of electronic mail and the Internet make it difficult for governments to determine cultural or communications policy, or to control the spread of information and cultural products.

However, an even more important aspect is the recent process by which global institutions have become major makers of an increasingly wide range of policies that are traditionally under the jurisdiction of national governments. Governments now have to implement policies that are in line with decisions and rules of these international institutions. The key institutions concerned are the World Bank, the IMF and the WTO.

There are also other influential international organizations, in particular the United Nations, its agencies, treaties and conventions and world conferences. However, in recent years, the UN has lost a lot of its policy and operational influence in economic and social matters, and correspondingly the powers and authority of the World Bank, IMF and GATT/WTO have expanded.

The Bretton Woods institutions wield tremendous authority in a majority of developing countries (and countries in transition) that depend on their loans. In particular, countries requiring debt rescheduling have to adopt structural adjustment policies (SAPS) that are mainly drawn up in the Washington institutions. SAPS cover macroeconomic policies and recently they also cover social policies and structural issues such as privatization, financial policy, corporate laws and governance. The mechanism of making loan disbursement conditional on these policies has been the main instrument driving the policy moves in the indebted developing countries towards liberalization, privatization, deregulation and a withdrawal of the State from economic and social activities. Loan conditionalities have thus been the major mechanism for the global dissemination of the macroeconomic policy packages that are favoured by governments of the North.

The Uruguay Round negotiations greatly expanded the powers of the GATT system, and the Agreements under the GATT's successor organization, the WTO, have established disciplines in new areas beyond the old GATT, including intellectual property rights, services, agriculture and trade-related investment measures. According to several analyses, the Uruguay Round has been an unequal treaty, and the WTO Agreements and system (including the decision-making system) are weighted against the interests of the South. The existing agreements now require domestic legislation and policies of member States to be altered and brought into line with them.

Non-compliance can result in trade sanctions being taken against a country's exports through the dispute settlement system, thus giving the WTO a strong enforcement mechanism. Thus, national governments have to comply with the disciplines and obligations in the already wide range of issues under WTO purview. Many domestic economic policies of developing countries are thus being made in the WTO negotiations, rather than in Parliament, bureaucracy or Cabinet at the national level.

There are now attempts by Northern governments to expand the jurisdiction of the WTO to yet more areas, including rights to be granted to foreign investors, competition policy, government procurement practices, labour standards and environmental standards. The greater the range of issues to be taken up by the WTO, the more will the space for national policy-making (and development options) in developing countries be whittled away.

Another major development is the proposal for a multilateral agreement on investments (MAI). The attempts at an MAI in the OECD have failed so far and attempts have been made to begin negotiations at the WTO for an international investment agreement. The original MAI model would require signatory States to remove barriers to the entry and operations of foreign companies in almost all sectors, allow them full equity ownership, and to treat foreign investors at least as well as local investors and companies. There would also be no controls over the inflow and outflow of funds, and requirements for technology transfer or other social goals would be prohibited. The MAI and similar types of investment agreements would be another major instrument in getting developing countries to open up their economies, in this case in the area of investment.

However, while the World Bank, IMF, WTO and the OECD are the most powerful, the United Nations and its agencies also form an alternative set of global institutions. Recent years have seen several UN World Conferences on Environment (1992), Population, Social Development (1995), Women (1995), Habitat (1996), Genetic Resources (1996), Food (1996), and the UNCTAD Conferences (1996 and 2000). The UN General Assembly and its subsidiary bodies, its agencies, Conferences and legally binding Conventions, which are much more transparent and democratic, also influence the content of globalization and as well as national policies, at least potentially.

The UN approach in economic and social issues is different from that of the WTO and Bretton Woods institutions. The latter promote the empowerment of the market, a minimal role for the State, and rapid liberalization. Most UN agencies on the other hand operate under the belief that public intervention (internationally and nationally) is necessary to enable basic needs and human rights to be fulfilled and that the market alone cannot do the job and in many cases hinders the job being done.

The Bretton Woods-WTO institutions have become much more powerful than the UN, whose authority and influence in the social and economic areas have been depleted in recent years. As a result, the type of globalization promoted by the Bretton Woods and WTO has predominated, while the type of globalization promoted by the UN has been sidelined. This reflects the nature of the globalization process. The former institutions promote the principles of liberalization, the laissez-faire market model and give high priority to commercial interests, and thus they are given the role to lead the globalization of policy-making. The UN and its agencies represent the principles of partnership, where the richer countries are expected to contribute to the development of the poorer countries and where the rights of people to development and fulfilment of social

needs are highlighted. The kind of globalization represented by the UN is not favoured by the powerful nations today, and thus the UN's influence has been curtailed.

### **C. Rising inequality and the effects of globalization**

“Globalization” is a very uneven process, with unequal distribution of benefits and losses. This imbalance leads to polarization between the few countries and groups that gain, and the many countries and groups in society that lose out or are marginalized. Globalization, polarization, wealth concentration and marginalization are therefore linked through the same process. In this process, investment resources, growth and modern technology are focused on a few countries (mainly in North America, Europe, Japan and East Asian NICs). A majority of developing countries are excluded from the process, or are participating in it in marginal ways that are often detrimental to their interests; for example, import liberalization may harm their domestic producers and financial liberalization may cause instability.

Globalization is thus affecting different categories of countries differently. This process can broadly be categorized as follows: growth and expansion in the few leading or fully participating countries; moderate and fluctuating growth in some countries attempting to fit into the globalization/liberalization framework; marginalization or deterioration experienced by many countries unable to get out of acute problems such as low commodity prices and debt, unable to cope with problems of liberalization, and unable to benefit from export opportunities.

The uneven and unequal nature of the present globalization is manifested in the fast growing gap between the world's rich and poor people and between developed and developing countries; and by the large differences among nations in the distribution of gains and losses.

The *UNDP Human Development Report, 1992* estimated that the 20 per cent of the world's population in the developed countries receive 82.7 per cent of total world income, while the 20 per cent of people in the poorest countries receive only 1.4 per cent (UNDP, 1992). In 1989, the average income of the 20 per cent of people living in the richest countries was 60 times higher than that of the 20 per cent living in the poorest countries. This ratio had doubled from 30 times in 1950.

The *Human Development Report, 1996* showed that over the past three decades, only 15 countries have enjoyed high growth, while 89 countries were worse off economically than they were ten or more years earlier. In 70 developing countries, the present income levels were less than in the 1960s and 1970s. “Economic gains have benefited greatly a few countries, at the expense of many”, said the report. Since 1980, 15 countries (mainly Asian) have had growth rates much higher than any seen during industrialization in the West. However, economic decline for most parts of the developing world has lasted far longer and gone deeper than during the Great Depression of the 1930s. While the rich countries mostly rebounded from the depression within four to five years, the lost decade of the 1980s is still continuing for hundreds of millions of people in many countries of Asia, Africa and Latin America. In some cases people are poorer than 30 years ago, with little hope of rapid improvement.

Wider inequalities among countries as well as among income groups within countries, which are closely associated with globalization processes, have been examined in detail in UNCTAD's *Trade and Development Report, 1997 (TDR.97)*. It shows that since the early 1980s the world

economy has been characterized by rising inequality, and North-South income gaps have continued to widen (UNCTAD, 1997: chaps. IV-VI). In 1965 the average per capita income of the G7 countries was 20 times that of the world's poorest seven countries; by 1995 it was 39 times as much. Polarization among countries has also been accompanied by increasing income inequality within countries. The income share of the richest 20 per cent has risen almost everywhere since the early 1980s and those at the bottom have failed to see real gains in living standards (in many countries the per capita income of the poorest 20 per cent now averages less than one tenth that of the richest 20 per cent) and the share of the middle class has also fallen. The increasing inequality is noted in more and less successful developing countries, and in all regions, including East Asia, Latin America and in Africa.

In the analysis of *TDR.97*, these trends are rooted in a set of forces unleashed by rapid liberalization that make for greater inequality by favouring certain income groups over others. They include the following: growing wage inequality in both the North and the South between skilled and unskilled workers (due mainly to declining industrial employment of unskilled workers and large absolute falls in their real wages); capital gaining in comparison with labour with profit shares rising everywhere; the rise of a new *rentier* class due to financial liberalization and the rapid rise in debt (with government debt servicing in developing countries also distributing income from the poor to the rich); and the benefits of agricultural price liberalization being reaped mainly by traders rather than farmers.

There are some particularly disturbing aspects of the increased inequality. Firstly, the increased concentration of national income in the hands of a few has not been accompanied by higher investment and faster growth. "It is this association of increased profits with stagnant investment, rising unemployment and reduced pay that is the real cause for concern" (UNCTAD, 1997, chap. VI). Secondly, some of the factors causing greater inequality in a globalizing world at the same time deter investment and slow down growth. For example: the fast pace of financial liberalization has delinked finance from international trade and investment; higher interest rates due to restrictive monetary policies have raised investment costs and led entrepreneurs to focus, instead, on buying and selling second-hand assets; the premium placed by global finance on liquidity and the speedy entry into and exit from financial markets for quick gains has undermined the "animal spirits" needed for longer-term commitments to investment in new productive assets; while corporate restructuring, labour shedding and wage repression have increased job and income insecurity (UNCTAD, 1997, chap. VI).

#### **D. Weaknesses of the South in facing the globalization challenge**

Most countries of the South have been unable to reap benefits from globalization because of several weaknesses. Nayyar (1997) examines this phenomenon of "uneven development", showing how globalization mainly benefits the developed world, while in the developing world, the benefits of accrue only to a few developing countries. There are only eleven developing countries which are an integral part of globalization in the late twentieth century. They accounted for 66 per cent of total exports from developing countries in 1992 (up from 30 per cent in the period 1970-1980); 66 per cent of annual FDI inflows to developing countries in 1981-1991; and most of portfolio investment flows to the developing world. Some of these eleven countries have since been badly affected by financial crises, debt and economic slowdown, thus diluting further the rate of success of the South in integration in the world economy.

The South's weaknesses stem from several factors. Developing countries were economically weak to begin with due to the lack of domestic economic capacity and weak social infrastructure following the colonial experience. They were made weaker by low export prices and significant terms-of-trade decline as well as the debt crisis and the burden of debt servicing. The policy conditionalities attached to loan rescheduling packages hampered the recovery of many countries and led to further deterioration in social services. Given the unequal capacities of North and South, the development of technology (especially information and communications technologies) further widened the gap. On top of these unfavourable international factors, many developing countries have also been characterized by dictatorships, abuse of power and economic mismanagement, which undermined the development process. All these factors meant that the South was in a weak position to take on the challenges of globalization, as the conditions for success in liberalization were not present. Given the lack of conditions and preparedness, rapid liberalization caused more harm than benefit.

The South's weakness also stems from its lack of bargaining and negotiating strength in international relations. Being heavily indebted and dependent on bilateral aid donors and multilateral loan organizations, developing countries have been drained of their capacity to negotiate (even on the terms of loan conditionalities). The powers of the United Nations, in which the South has been in a more favourable position, have been diminished, whereas the mandate and powers of the institutions under the control of developed countries (the IMF, World Bank and WTO) have been increased tremendously. The North has leverage in the Bretton Woods institutions and the WTO to shape the content of globalization to serve their needs, and to formulate policies which the developing countries have to take on.

Although the North is in a dominant position and has been prepared to use this to further their control of the global economy, the South is also not helpless but can better organize its responses as well as its own proposals. However, the South has as a whole not done well in organizing itself to coordinate on substantial policy and negotiating positions, or on strategy in relation to the discussions and negotiations in the WTO and IMF as well as other forums.

The developed countries are well placed to determine the globalization agenda. They are well organized within their own countries, with well staffed departments dealing with international trade and finance, and with university academics and private and quasi-government think tanks helping to obtain information and map policies and strategies. They also have well-organized associations and lobbies associated with their corporations and financial institutions, which have great influence over the government departments. The developed countries also have institutions and mechanisms helping to coordinate their policies and positions, for example the European Commission, the OECD and the Group of Seven, and their subsidiary bodies and agencies.

In contrast, the developing countries are not well organized within their own countries. The government departments dealing with the interface with the global economy are understaffed, especially in relation to the rapid developments in globalization and in global negotiations. The academic sector and the few think-tanks are not geared up to obtain and assess information on globalization trends, and less still to formulate policy proposals that governments can make use of. The links between these intellectual sectors, the NGOs and governments are also often weak. The business and financial community is not organized well enough to monitor global trends, or to lobby governments on global issues. At the regional level, there is increasing collaboration among the countries, through regional groupings. However, cooperation is still not as sophisticated as in the European Union. At the international level, the South is organized through the Group of 77 and

the Non-Aligned Movement. These groupings often perform reasonably effectively within the UN framework and at UN meetings and Conventions. However, they are not adequately staffed, they are unable to keep track adequately of events and developments, or to formulate longer-term policies and strategies. At the WTO, IMF and World Bank, the collective strength of developing country members has yet to be manifested in a strong way, although there are encouraging signs of more collaboration, for example at the WTO.

## **II. KEY ISSUES IN TRADE**

### **A. General**

Openness to international trade is not a recent phenomenon for developing countries. In the colonial period, they had related to the world market mainly as exporters of raw materials while importing manufactures. This division of labour is still prevalent for a large number of developing countries, whose exports comprise mainly a few commodities. Perhaps the most important aspect of globalization in trade for a majority of developing countries is the continuing decline in the terms of trade for their commodity exports vis-à-vis their imports of manufactures. The decline has become more acute in recent years, and has been responsible for the transfer of a huge volume of real resources from commodity-exporting developing countries through the mechanism of income losses arising from terms-of-trade changes. Other problems facing developing countries have been the pressures for import liberalization, under loan conditionality; the imbalances in the Uruguay Round agreements; the lack of benefits relative to expectations accruing from the Uruguay Round; and the problems arising from their having to fulfil several of the WTO Agreements. These issues are discussed in this Part III.

### **B. Commodity prices and terms of trade**

The colonial pattern of trade, in which colonies exported raw materials and colonial master countries specialized in producing industrial products, has continued in the main to the present. Many Southern countries still mainly export primary commodities (mainly to the North) and import industrial products (mainly from the North). As the terms of trade of commodities has been falling continuously against manufactured goods, many Southern countries have suffered tremendous losses.

According to United Nations data, the terms of trade of non-fuel commodities vis-à-vis manufactures fell from 147 in 1980 to 100 in 1985 to 80 in 1990 and 71 in 1992. This sharp 52 per cent fall in terms of trade between 1980 and 1992 had catastrophic effects. A paper by the secretariat of the United Nations Conference on Environment and Development (UNCED) in 1991 showed that for sub-Saharan Africa, a 28 per cent fall in terms of trade between 1980 and 1989 led to an income loss of \$16 billion in 1989 alone. In the four years 1986–1989, sub-Sahara Africa suffered \$56 billion income losses, or 15–16 per cent of GDP in 1987–1989. The UNCED study also showed that for 15 middle-income highly indebted countries, there was a combined terms of trade decline of 28 per cent between 1980 and 1989, causing an average of \$45 billion loss per year in the 1986–1989 period, or 5–6 per cent of GDP (Khor, 1993).

In the 1990s decade, the general level of commodity prices fell even more in relation to manufactures, and many commodity-dependent developing countries have continued to suffer deteriorating terms of trade. According to *Trade and Development Report, 1999 (TDR.99; UNCTAD, 1999a: 85)*, oil and non-oil primary commodity prices fell by 16.4 and 33.8 per cent respectively, from the end of 1996 to February 1999, resulting in a cumulative terms-of-trade loss of more than 4.5 per cent of income during 1997–1998 for developing countries. “Income losses were greater in the 1990s than in the 1980s not only because of larger terms-of-trade losses, but also because of the increased share of trade in GDP.” Moreover, the prices of some key manufactured products exported by developing countries have also declined. For example, the Republic of Korea experienced a 25 per cent fall in the terms of trade of its manufactured exports between 1995 and 1997 due to a glut in the world market (UNCTAD, 1999a: 87).

The income losses from falling terms of trade probably constitute the largest single mechanism by which real economic resources are transferred from South to North. These losses adversely affect the sustainable development prospects of the South, as they contribute to the debt problem and to persistent poverty in many communities.

The world trading system has been favouring the exporters of manufactured goods, while proving to be disadvantageous to the many developing countries whose main participation in global trade has been the export of raw materials and commodities and the import of finished products. Many Southern countries have lost their self-reliance in terms of producing their own food, as lands were converted to export crops that in many cases yielded unsatisfactory results in terms of instability of price and demand.

Attempts were made by developing countries to obtain fairer prices and more stable demand conditions for their commodities through commodity agreements involving producer and consumer countries, under the auspices of UNCTAD. Most of these agreements collapsed when the industrial countries, which are the main consumers of commodities, withdrew support in the 1980s. Many Southern countries, especially in Africa, are thus today even more subjected to the vagaries of the commodity markets.

With oversupply of many commodities and stagnating demand and trend decline in prices, many developing countries still dependent on commodity exports have been trapped in a bad corner of the world trading system.

The commodities situation may worsen for developing countries should major consumer countries (in the North) develop laboratory substitutes for natural commodities through the use of biotechnology. There would be more displacement of the South’s export commodities.

### ***Proposals***

- (i) The problem of trend decline in commodity prices and in the South’s terms of trade should be seriously addressed through an international conference or convention, or other institutional mechanisms. It is imperative that such huge income losses incurred by poor countries should be stemmed.
- (ii) Countries could reconsider their attitude towards commodity agreements or other methods of cooperation between producers and consumers since leaving commodity trade to the full force of monopoly markets has resulted in negative social and



environmental effects. One possibility is to initiate a new round of commodity agreements aimed at rationalizing the supply of raw materials (to take into account the need to reduce depletion of non-renewable natural resources) while ensuring fair and sufficiently high prices (to reflect ecological and social values of the resources).

- (iii) In the absence of joint producer-consumer attempts to improve the commodity situation, producers of export commodities could take their own initiative to rationalize their global supply so as to better match the profile of global demand. The recent sharp increase in the price of oil as a result of better coordination among producing countries is a good reminder of the benefits that producers can derive through greater cooperation.
- (iv) An improvement of the South's terms of trade vis-à-vis the North would be a valuable mechanism to stem and reverse the current South-to-North flow of economic resources. It would help create conditions for a more equitable trading system, reduce resource wastage and unsustainable consumption patterns, and expand financial resources in the South for the transition to sustainable development.
- (v) The relevant international agencies including UNCTAD should monitor and analyse the implications of biotechnology for developing-country commodities. Measures should be taken if impact assessments show significant negative effects on incomes and livelihoods in the South. Signatory members of the Biosafety Protocol under the Convention on Biological Diversity should exercise the protocol's mandate to consider the social implications of developments in biotechnology especially on developing countries.

### **C. Trade liberalization**

The benefits and costs of trade liberalization for developing countries constitute an increasingly controversial issue. The conventional view that trade liberalization is necessary and has automatic and generally positive effects for development is being challenged empirically and analytically. It is timely to examine the record and to formulate appropriate approaches towards trade policy in developing countries.

There is a paradox in the manner developing countries in general and many scholars take towards this issue. On one hand it is almost invariably repeated that "we are committed to trade liberalization which is positive for and essential to growth and development". On the other hand, many developing countries also notice and are now actively complaining that trade liberalization has produced negative results for their economies, or has marginalized them.

The notion that all are gainers and there are no losers in trade liberalization has proven to be overly simplistic. Some countries have gained more than others; and many (especially the poorest countries) have not gained at all but may well have suffered severe loss to their economic standing. Only a few countries have enjoyed moderate or high growth in the last two decades while an astonishing number have actually suffered declines in living standards (measured in per capita income). The UNDP's *Human Development Report, 1999* states: "The top fifth of the world's people in the richest countries enjoy 82 per cent of the expanding export trade and 68 per cent of

FDI – the bottom fifth, barely more than 1 per cent. These trends reinforce economic stagnation and low human development. Only 33 countries managed to sustain 3 per cent annual growth during 1980–1996. For 59 countries (mainly in sub-Saharan Africa and Eastern Europe and the CIS) GNP per capita declined. Economic integration is thus dividing developing and transition economies into those that are benefiting from global opportunities and those that are not” (UNDP, 1999: 31).

A clear explanation of why trade liberalization has had negative results is found in *TDR.99*. The report found that for developing countries (excluding China) the average trade deficit in the 1990s was higher than in the 1970s by 3 percentage points of GDP while the average growth rate was lower by 2 percentage points. In discussing why trade deficits have been increasing faster than income in developing countries, the report concludes: “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” (UNCTAD, 1999a, chap. VI).

On the role of rapid trade liberalization in generating the wider trade deficits, the UNCTAD report said: “It (trade liberalization) 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”.

One conclusion that can be drawn from the report is that if trade liberalization is carried out in an inappropriate manner in countries that are not ready or able to cope, or which face conditions that are unfavourable, it can contribute to a vicious cycle of trade and balance-of-payments deficits, financial instability, debt and recession.

The UNCTAD report’s findings correspond with some recent studies that show there is no automatic correlation between trade liberalization and growth. Countries that rapidly liberalized their imports did not necessarily grow faster than those that liberalized more gradually or in more strategic ways.

For example, in a study of 41 least developed countries, the UNCTAD senior researcher Mehdi Shafaeddin (1994) found “no clear and systematic association since the early 1980s between trade liberalization and devaluation, on the one hand, and the growth and diversification of output and growth of output and exports of LDCs on the other. In fact, trade liberalization has been accompanied by deindustrialization in many LDCs, and where export expanded it was not always accompanied by the expansion of supply capacity”. By contrast, the paper attributes success or failure of GDP and industrial growth to the volume of investment and availability of imports. “The design of trade policy reforms has also been an important factor in performance failure.”

The Harvard University economist Dani Rodrick (1999) argues that developing nations must participate in the world economy on their own terms, not the terms “dictated” by global markets and multilateral institutions. Noting the premise that reducing barriers to imports and opening to capital flows would increase growth and reduce poverty in developing countries, Rodrik’s study concludes: “The trouble is, there is no convincing evidence that openness, in the sense of low

barriers to trade and capital flows, systematically produces these results. The lesson of history is that ultimately all successful countries develop their own brands of national capitalism. The States which have done best in the post-war period devised domestic investment plans to kick-start growth and established institutions of conflict management. An open trade regime, on its own, will not set an economy on a sustained growth path”.

A major problem faced by developing countries in the trade liberalization process is that a country may be able to control how fast to liberalize its imports (and thus increase the inflow of products) but cannot determine by itself how fast its exports grow. Export performance partly depends on the prices of the existing exported products (and developing countries have suffered from serious declines in the prices of their commodity exports and their terms of trade) and also on having or developing the infrastructure, human and enterprise capacity for new exports (which is a long-term process and not easily achieved).

Export performance in developing countries also depends on whether there is market access for the country's potential exports, especially in developed countries. Herein lies a major problem beyond the control of the South, for as is well known there are many tariff and non-tariff barriers in the North to the potential exports of developing countries. Unless these barriers are removed, the South's export potential will not be realized. As an UNCTAD note on *TDR.99* put it: “Developing countries have been striving hard, often at considerable cost, to integrate more closely into the world economy. But protectionism in the developed countries has prevented them from fully exploiting their existing or potential competitive advantage. In low-technology industries alone, developing countries are missing out on an additional \$700 billion in annual export earnings as a result of trade barriers. This represents at least four times the average annual private foreign capital inflows in the 1990s (including FDI)” (UNCTAD, 1999b).

Thus, trade liberalization can (and often) causes imports to surge without a corresponding (or correspondingly large) surge in exports. This can cause the widening of trade deficits, deterioration in the balance of payments and the continuation or worsening of external debt, which act to constrain growth prospects and often result in persistent stagnation or recession.

### ***Proposals***

- (i) Trade liberalization should not be pursued automatically, rapidly, as an end in itself, or in a “big bang” manner. Rather, what is important is the quality, timing, sequencing and scope of liberalization (especially import liberalization), and how the process is accompanied by (or preceded by) other factors such as the strengthening of local enterprises and farms, human resource and technological development, as well as the build up of export capacity and markets. A logical conclusion must be that if conditions for success are not present yet in a country, then to proceed with liberalization can lead to specific negative results or even a general situation of persistent recession. Thus, to pressurize such countries to liberalize would be to help lead them into an economic quagmire. Thus, multilateral institutions should not take the approach of putting pressure on developing countries to rapidly liberalize their trade.
- (ii) Developing countries must have the ability, freedom and flexibility to make strategic choices in finance, trade and investment policies, where they can decide on the rate and scope of liberalization and combine this appropriately with the defence of local firms and farms.

- (iii) Caution must thus be exercised when considering proposals for measures that would bind developing countries to further import liberalization, for example through proposed new issues (such as another round of industrial tariff cuts) in the WTO. Imbalances and inequities in the world trading system should be tackled as a priority; in doing so, developed countries should increase the access to their markets of products from developing countries, but they should not press the developing countries to further open up their markets to Northern products. Developing countries should be allowed greater flexibility to choose their own rate of trade liberalization.

## **D. The WTO and the multilateral trading system**

### ***1. General***

The failure of the WTO's Ministerial meeting in Seattle in November/December 1999 is an opportunity for all countries, and especially developing countries, to review the framework, rules and effects of the multilateral trading system, from the viewpoint of development and the interests of developing countries. The collapse of the Seattle meeting had its roots in both the system of decision-making and the substance of the negotiations. In the many months of the preparatory phase, developing countries generally were more concerned about their non-benefits from the WTO Agreements and about the need to correct the problems of implementation. Most of them were not in the frame of mind to consider or welcome the new issues being proposed by developed countries. The latter on the other hand were strongly promoting several new issues, such as investment, competition policy, transparency in government procurement, a new round of industrial tariff cuts, and labour and environmental standards. At Seattle, the United States pushed for labour standards led by President Clinton (who linked the issue to the use of trade sanctions) seemed to confirm the fears of developing countries that the WTO was sought to be tilted even more against them by the major powers.

The clash of interests over substance was worsened by the organization of the meeting and the lack of transparency in the multitude of talks held in small groups that the majority of developing country members had no access to. Many developing country delegations made it clear, including through open statements and media conferences, that they would not join in a "consensus" of any Declaration in which they had no or little part in formulating. The talks had to be abandoned without the issuing of a Declaration by Ministers.

The tasks ahead in the needed reform of the multilateral trading system include the need to address both substance and process. The grievances of developing countries – that they have not benefited from the Uruguay Round, and that the problems of implementation of these Agreements have to be rectified – must urgently and seriously be tackled. The process of decision-making and negotiations in the WTO has to be democratized and made transparent. "Green Room" meetings that are not mandated by the general membership should be discontinued. Every member, however small, must have the right to know what negotiations are taking place, and to take part in them. The following sections cover some of these issues in more detail.

## ***2. Lack of realization of anticipated benefits for developing countries from the Uruguay Round***

When the Uruguay Round was concluded and the WTO established, developing countries had expected to benefit significantly from the anticipated increased access to the markets of developed countries for products (especially in the textiles and agriculture sectors) for which they had a comparative advantage. However, several years later, officials from many developing countries are complaining that their countries have not benefited and the expected benefits to them have not materialized due to the non-implementation of the commitments of the developed countries.

The main problems include the following:

### *(a) Tariff peaks remain*

A lowering of Northern countries' industrial tariffs is supposed to benefit those Southern countries with a manufacturing export capacity. However, "tariff peaks" (or high import duties on certain products) remain in the rich countries for many industrial products that developing countries export. This means that some potential exports of developing countries are still blocked.

### *(b) No gains yet from the supposed phasing out of textiles quotas*

The Uruguay Round's agreement on textiles and clothing was aimed at phasing out the special treatment of the textiles and clothing sector, in which the developing countries for the past quarter century had agreed to subsidize the North by allowing quotas to be placed on their exports in this sector. This ten-year phase-out was supposed to be the aspect of the Uruguay Round to most immediately benefit the South, or at least the Southern countries that export textiles, clothing and footwear.

However, textile-exporting developing countries have been disappointed and frustrated that five years after the phase-out period began, they have not yet seen any benefits. This is due to the "endloading" of the implementation of developed countries (that is, the liberalization of most of the products they buy from developing countries will take place only in the final year or years), and the benefits will accrue only at the end of the ten year phase-out period. Although developed countries have legally complied with the agreement by phasing out quotas proportionately, in fact they have chosen to liberalize on products that are listed but which they have not actually restrained in the past. As a result, developing countries have not benefited. They have made proposals several times that the developed countries improve the quality of their implementation of the agreement on textiles and clothing.

### *(c) Increase in non-tariff barriers such as anti-dumping measures*

Developing countries are also concerned that the supposed improvement of market access through tariff reductions is being offset by an increase in non-tariff barriers in the rich countries. A major problem has been the use (or rather misuse) of anti-dumping measures, especially by the United States and the European Union, on products of developing countries, including on textiles.

Many countries have proposed that the misuse of these measures be curbed by amendments to the Anti-Dumping Agreement.

*(d) Continued high protection in agriculture*

The Agriculture Agreement was supposed to result in the import liberalization and reduction of domestic support and export subsidies for agricultural products especially in the rich countries, and this was expected to improve the market access of those Southern countries that export agricultural products. As it turned out, however, the protection and subsidies have been allowed to remain very high. For example, in the initial year of the agreement, there were very high tariffs in the United States (sugar 244 per cent, peanuts 174 per cent), EU (beef 213, wheat 168 per cent); Japan (wheat 353 per cent), Canada (butter 360 per cent, eggs 236 per cent) (Das, 1998: 59). The rich countries have to reduce such high rates by only 36 per cent on average to the end of 2000. The tariffs have thus been still very high, making it impossible for developing countries' exports to gain access.

Also, the Agreement has allowed the developed countries to maintain most of the high subsidies that existed prior to the Uruguay Round conclusion. For example, they are obliged to reduce their very high domestic subsidies by only 20 per cent. In contrast most developing countries had no or little domestic or export subsidies earlier. They are now barred by the Agriculture Agreement from having them or raising them in future (Das, 1998: 62). There is a great imbalance in this odd situation.

**3. *“Implementation problems” faced by developing countries from the Uruguay Round***

Developing countries generally are also facing problems in their having to implement their obligations in the WTO Agreements. The Uruguay Round resulted in several new legally binding agreements that require them to make changes to their domestic economic policies in such diverse areas as services, agriculture, intellectual property and investment measures. Many developing countries did not have the capacity to follow the negotiations, let alone participate actively, and did not fully understand what they committed themselves to. Some of the agreements have a grace period of five years before implementation, which expired at the end of 1999. Thus, the problems arising from implementation may get more acute.

*(a) Main problems*

The following are some of the major general problems:

- C Having to liberalize their industrial, services and agriculture sectors may cause many developing countries dislocation to their local sectors, firms and farms as these are generally small or medium sized and unable to compete with bigger foreign companies or cheaper imports; and this could threaten jobs and livelihoods of local people.
- C The Uruguay Round removed or severely curtailed the developing countries' space or ability to provide subsidies for local industries and to maintain some investment measures such as requiring that investors use a minimum level of local materials in their production. This could affect the viability of some local firms and sectors.
- C The TRIPS agreement will severely hinder or prevent local firms from absorbing or some modern technologies over which other corporations (mainly foreign firms) have intellectual property rights; this would curb the adoption of modern technology by domestic firms in

developing countries. Also, the prices of medicines and other essential products are expected to rise significantly when the new IPR regime takes effect in the next few years.

The following is a summary of some of the concerns of developing countries regarding some of the Agreements:

*(b) The Agriculture Agreement*

The Agriculture Agreement could have severe negative effects on many third world countries. Most of them (excepting the least developed countries) will have to reduce domestic subsidies to farmers and remove non-tariff controls on agricultural products, converting these to tariffs and then progressively reducing these tariffs. This will impose global competition on the domestic farm sector and may threaten the viability of small farms that are unable to compete with cheaper imports. Many millions of small third world farmers could be affected. There is also a category of developing countries which are net food importers; as subsidies for food production are progressively reduced in the developed countries, the prices of their exports may increase; the net food importers may thus face rising food import bills.

A recent FAO study of the experience of 16 developing countries in implementing the Uruguay Round agriculture agreement concluded that: "A common reported concern was with a general trend towards the concentration of farms. In the virtual absence of safety nets, the process also marginalized small producers and added to unemployment and poverty. Similarly, most studies pointed to continued problems of adjustment. As an example, the rice and sugar sectors in Senegal were facing difficulties in coping with import competition despite the substantive devaluation in 1994" (FAO, 1999).

*Proposal:* Many developing countries during the preparations for the WTO's Seattle Ministerial meeting had proposed to amend the Agriculture Agreement to take into account their concerns of implementation, especially the effects on rural livelihoods and food security. Several developing countries have proposed that developing countries be given flexibility in implementing their obligations on the grounds of the need for food security, defence of rural livelihoods and poverty alleviation. They proposed that in developing countries, food produced for domestic consumption and the products of small farmers shall be exempted from the Agriculture Agreement's disciplines on import liberalization, domestic support and subsidies. This proposal should be pursued further by the developing countries in the future negotiations on agriculture at the WTO.

*(c) The TRIMS (Trade-Related Investment Measures) Agreement*

In the TRIMS Agreement, "investment measures" such as local content (obliging firms to use at least a specified minimal amount of local inputs) and foreign exchange balancing (that limit the import of inputs by firms to a certain percentage of their exports) will be prohibited for most developing countries from January 2000. Such measures had been introduced to protect the country's balance of payments, promote local firms and enable more linkages to the local economy. The prohibition of these investment measures will make the attainment of development goals much more difficult and cause developing countries to lose some important policy options to pursue their industrialization.

*Proposal:* Several developing countries proposed in the pre-Seattle negotiations in the WTO that TRIMS be amended to provide developing countries the flexibility to continue using such investment measures to meet their development goals. In the review of the TRIMS Agreement, which is scheduled to begin in 1999, the problems of implementation for developing countries should be highlighted. The TRIMS Agreement could be amended to allow developing countries the right to have “local content” policy and to limit the import of inputs to a certain percentage of a firm’s exports.

*(d) The TRIPS (Trade-Related Intellectual Property Rights) Agreement*

The South’s collective loss in the Uruguay Round was most acutely felt in the agreement on TRIPS (Trade Related Intellectual Property Rights) through which countries are obliged to introduce IPR legislation with standards of protection that are similar to Northern countries. This will hinder Southern countries’ indigenous technological development. It should be noted that the present industrial countries did not have patent or IPR laws, or laws as strict as will now be imposed through TRIPS, during their industrializing period, and this enabled them to incorporate technology design originating from abroad in their local systems.

The agreement will also give rise to increasing technical payments such as royalties and license fees to transnational companies that own most of the world’s patents.

The new IPR regime will also have significant impact on raising the prices of many products. By restricting competition, the IPR rules will enable some companies to raise the prices of their products far beyond costs and thus earn rents in terms of monopoly revenues and profits.

Also, most third world countries have in the past exempted agriculture, medicines and other essential products and processes from their national patent laws, but with the passage of TRIPS, all products are subject to IPRs unless explicitly exempted. The prices of medicines are expected to shoot up in many countries, reducing access to consumers. The problem of the inability of AIDS patients in developing countries to have access to patented drugs due to their high prices has already become a major issue of concern.

The TRIPS agreement also opens the door to the patenting of life forms such as micro-organisms and modified genetic materials. Many environmentalists are concerned that this will be detrimental to the global environment as the present lack of controls and accountability in biotechnology research and application will likely accelerate biodiversity loss and could threaten natural ecosystems. For plant varieties, TRIPS does permit countries the option to either introduce patents or an alternative “effective” *sui generis* system of intellectual property protection. Many governments, NGOs and farmers’ groups in developing countries are concerned that the practice of “biopiracy” (patenting in the North of biological materials and resources originating in the South) will intensify. Moreover, unless appropriate *sui generis* systems are established in developing countries, that protect the traditional knowledge and genetic resources of farmers, these farmers may be further disadvantaged by plant variety protection regulations.

*Proposal:* Given these many problems, the TRIPS agreement should be amended to take into account development, social and environmental concerns. Meanwhile, the grace period before implementation should be extended. Many developing countries have made formal proposals before and at Seattle that a review of TRIPS along these lines be made and that there should be



an extension of the implementation dateline. These and other proposals can be pursued in the process of the review of TRIPs.

Recently there have been calls from some eminent economists and from some NGOs to study whether the TRIPs Agreement should be taken out of the WTO. Their argument is that TRIPs is a protectionist device, and should have no place in an organization that is supposed to be committed to liberalization. Moreover, IPRs is not a trade issue. By locating it in the trade system, the road is open to overload the WTO with more non-trade issues.

*(e) Conclusion*

These are only a few examples of serious problems facing developing countries in implementing their WTO obligations, now and especially in future. Thus, many of the countries are arguing that they need time to digest the Uruguay Round, that some of the rules that are imbalanced or inequitable and that generate serious problems should be reviewed, and amended. In fact some of the Agreements themselves mandate that reviews be carried out. The next phase of the WTO's activities should focus on the review process, so that the opportunity to rectify the defects of the Agreements can be taken. This review process would in itself be a massive task, involving analyses of the weaknesses of the various Agreements, assessments of how they have affected or will affect developing countries, proposals to amend the Agreements, and negotiations on these proposals.

**4. Pressure for new issues in WTO**

A major reason for the failure at Seattle was the reluctance of many developing countries to give the WTO a mandate for taking on new issues or negotiating new agreements, which had been proposed by some of the developed countries.

There is much merit in the view that the WTO should focus in the next few years on reviewing problems of implementing the Agreements and making the necessary changes in the agreements. These will be enormous tasks. They will not be properly carried out if there is a proliferation of new issues in a new Round. The extremely limited human, technical and financial resources of developing countries and their diplomats and policy makers would be diverted away from the review process to defending their interests in the negotiations on new issues. The limited time of the WTO would also be mainly engaged in the new issues.

Moreover, most of the proposed new issues would also have the most serious consequences for the South's future development. Issues such as investment rules, competition policy and government procurement are strictly not trade issues and it has been argued that they do not belong to the WTO. There is a suspicion on the part of some developing countries that these issues are sought to be placed there by the developed countries to take advantage of the enforcement capability (the dispute settlement system) of the WTO, so that disciplines can be effectively put on developing countries to open their economies to the goods, services and companies of the developed countries. Other issues relate to labour, social and environment standards. Most developing countries have argued that these issues should also not enter the WTO as they could be made use of as protectionist devices against the products and services of developing countries.

Should pressure be continued to be applied for these new issues to be accepted into the WTO, then the WTO will continue to be split, and, moreover, other pressing issues such as the problems resulting from the existing Agreements would not be tackled.

### **5. *General proposals***

- (i) In the WTO, members should take a more realistic approach towards liberalization, with a slowdown to pressures being put on developing countries for further liberalization. If the developed countries continue after so many years to maintain such high protection in agriculture, textiles and some industrial products (and argue that they need more time to adjust), then developing countries should not be subjected to more pressures to continuously liberalize on the ground that it is automatically good for them.
- (ii) It should be reasserted that the main objective of the multilateral trading system is the development of developing countries which form the majority of the membership. Liberalization is a means, and there should be sufficient flexibility to implement measures when appropriate. The goal and dimension of development must be primary in WTO rules and in the assessment of proposals. The “special and differential treatment” principle should be greatly strengthened operationally, above its present weak State.
- (iii) Resolving the problems of implementation of the Uruguay Round agreements should be given the top priority at the WTO. The following steps should be taken:
  - (a) Developed countries should greatly increase access in their markets for developing countries’ products, such as in agriculture, textiles and industrial products (where there are now high tariffs); moreover, they should stop taking protectionist measures such as anti-dumping measures;
  - (b) In the areas where developing countries face problems in implementing their obligations, a systematic exercise to review and amend the existing rules should be carried out as a matter of priority;
  - (c) In the meanwhile, where the transition period for implementation for developing countries has expired, an extension should be given at least until the review process is completed. There should also be a moratorium on bringing dispute cases against developing countries on issues where the reviews are taking place.
- (iv) There should not be pressures to introduce new issues such as investment, competition, procurement, labour and environmental standards in the WTO as these would overload the multilateral trading system further and lead to more systemic stress and tensions.
- (v) As the Seattle meeting showed, there is a need for serious reform to the system and culture of decision making in the WTO. The reform process itself should be conducted in a manner whereby all members can fully participate. The reform should aim at a result whereby WTO meetings are run on the basis of full transparency and participation, where each member is given the right to be present and to make proposals. Even if some system of group representation is considered, all members

should be allowed to be present at meetings and have participation rights. The secretariat should also be impartial and seen to be impartial. The system should reflect the fact that the majority of members are now from developing countries which have as much stake or more in a truly fair and balanced multilateral system as the developed countries, and therefore the system must be able to provide the developing countries with adequate means with which to voice their interests and exercise their rights.

### **III. KEY ISSUES IN FINANCE**

#### **A. Financial liberalization**

Globalization in the financial sector has been driven by several factors. Among the major ones are: the policy choice of an increasing number of countries (starting with the developed economies, then taken on by many developing countries) of financial deregulation and liberalization (the opening up by a country to international capital flows); the development of technology, especially electronic communications (facilitating the massive cross-border movements of funds); the emergence of new financial instruments (such as derivatives) and financial institutions (such as highly-leveraged hedge funds); and the collapse of the international fixed exchange-rate system (thus making it possible for profit to be made from speculation on changes in the rates of currencies).

Financial liberalization is a relatively recent phenomenon, but it has contributed to severe financial turmoil and economic losses to several developing countries that have integrated into the global financial markets. The developing countries had been drawn into the process of financial liberalization partly due to advice given by international financial institutions and to the mainstream view that there were great benefits to be derived from opening up to inflows of international capital. However, the risks of also opening up to volatility of short-term capital flows and to financial speculation and manipulation were not emphasized by the same advisors. Many developing countries that underwent the process of financial liberalization did not take precautionary measures or adhere to guidelines to minimize the risks. Instead, they went the opposite direction by deregulating, removing existing capital controls, allowing private banks and companies to take foreign-currency loans, and allowing the trading abroad of their local currency.

Having deregulated and liberalized their capital accounts, many developing countries were unable to defend themselves from the huge flows of international funds whose volumes have expanded dramatically in the past two decades, and from the new financial instruments and institutions (especially highly-leveraged funds) that have emerged in the field of financial speculation.

#### **B. Volatility and negative effects of short-term capital flows**

The latest round of financial crises that hit emerging markets, starting with Thailand in mid-1997 and spreading rapidly to other East Asian countries before also affecting Russia and Brazil, has dramatically exposed the negative effects caused by volatile short-term capital flows and the grave risks and dangers that accompany financial liberalization in developing countries. The latest

crisis has also exposed the fallacy of the orthodox view that opening up to global finance would bring only or mainly benefits and little costs to developing countries. The Asian crisis followed a period of financial liberalization, which contributed to a build-up of vulnerability of the countries to external financial forces. When large inflows of short-term capital took place, it led to an asset price bubble that broke when speculative currency attacks and large capital outflows caused sharp depreciations which spread via contagion to other countries. The depreciations multiplied the burden of servicing foreign debt which had built up in a relatively short period especially by the local companies and banks. When Indonesia, the Republic of Korea and Thailand ran out of foreign reserves to service the debts, they approached the IMF to bail them out with massive loans.

Almost alone among international agencies, UNCTAD had been warning for several years about the dangers and costs of financial liberalization. In the early and mid-1990s, its *Trade and Development Reports* and *Discussion Papers* had raised the alarm about the volatility of short-term capital and the serious destabilizing economic and social effects of financial liberalization, especially for developing countries. The Asian crisis validated the UNCTAD analysis and warnings. The crisis has also stimulated a general questioning of the orthodox approach and the start of a change in opinion and perhaps of paradigm.

As UNCTAD Secretary-General Rubens Ricupero stated, in his closing speech at UNCTAD X in February 2000: “When trouble came, starting in Thailand in 1997, it brought with it a reversal of opinion. That episode revealed the sheer size of the financial flows that the industrial world could generate, relative to the normal size of flows of developing countries. The swift entry, and even swifter exit, of such massive flows made clear for all to see the havoc that can be unleashed on small and fragile financial systems that are open to such tidal waves of finance. Despite the commitment of many international agencies to the complete liberalization of capital markets right up to (and beyond) the hour of Asia’s crisis, the same agencies now say that they can see some virtues in certain types of capital controls....Positive processes of integration into the world economy are the goal. This has never changed. However, the liberalization measures that are necessary to this end must be phased in a prudent and orderly manner. They must take account of specific local circumstances, they must be complemented by appropriate domestic policies and accompanied by institution- and capacity-building. Only then can they hope to succeed” (Ricupero, 2000).

Also at UNCTAD X, Yilmaz Akyüz, Head of the UNCTAD Macroeconomic and Development Policies Branch, summed up the lessons of the crises that hit Asia and other regions as follows: “The crisis has shown that when policies falter in managing integration and regulating capital flows, there is no limit to the damage that international finance can inflict on an economy. It is true that control and regulation over such flows may reduce some of the benefits of participating in global markets. However, until systemic instability and risks are adequately dealt with through global action the task of preventing such crises falls on governments in developing countries” (Akyüz, 2000).

One of the most incisive analyses of the Asian Crisis is presented in *Trade and Development Report, 1998 (TDR.98; UNCTAD, 1998: 53–109)*. It shows that financial crises are very much part of the global system and the Asian case is only one. It gives a critique of why the IMF response converted a liquidity problem into a solvency crisis. Finally, it also proposes a range of crisis management measures, including a debt standstill and capital controls.

As *TDR.98* shows, the East Asian experience is only one of a series of many financial crises (for example, in Southern Cone of Latin America in the late 1970s and early 1980s, Latin America in the 1980s, European countries in 1992, Mexico in 1994) of the past two decades. These crises are caused by the intrinsic and volatile nature of the global financial system, after the closure of the fixed exchange rate system in the early 1970s.

### **C. Inappropriate response to debt crises and financial crises**

A significant aspect of financial crises in developing countries is that the policy responses may often not be appropriate and could even make the situation worse. The “structural adjustment” policies accompanying IMF-World Bank loans to heavily indebted developing countries as conditionality have been criticized for depressing their economies through high interest rates and large budgetary cuts; and many of the countries concerned have remained indebted.

The policy responses in the East Asian countries that also sought IMF assistance when the financial crisis broke in 1997 have also been widely acknowledged to be inappropriate. Once the countries fell into crisis, the IMF’s response (monetary and fiscal tightening and high interest rates while maintaining or even extending capital mobility) made it worse.

In one of the deepest critiques of the IMF approach, *TDR.98* pointed out that the situation was characterized by a stock disequilibrium rather than a flow imbalance that could be corrected by expenditure reduction. The fall in the currency created a balance sheet disequilibrium for indebted banks, property companies and firms. The value of firms and assets thus declined. Since these assets had been the collateral for much of the increased lending, the quality of bank loans automatically deteriorated. Rather than ease the burden of refinancing on domestic firms by granting additional credit, the recommended policy response was to raise interest rates. This depressed asset prices further and increased balance sheet losses of firms and their need to repay or hedge their foreign indebtedness quickly by liquidating assets and selling the domestic currency.

The report also pointed out that instead of the IMF loans going to support the new exchange rates, in East Asia the exchange rates were left to float. Thus, rather than guaranteeing the new exchange rate, the Fund’s lending was aimed at ensuring the maintenance of the domestic currency’s convertibility and free capital flows, and guaranteeing repayment to foreign lenders. The latter, unlike domestic lenders, emerged from the crisis without substantial loss, even though they had accepted exposure to risk just as other lenders had done.

According to UNCTAD, the crisis was initially one of liquidity rather than of solvency. As long as they were given sufficient time to realize their investments, the countries would have been able to generate foreign exchange to repay their external debt with an exchange rate adjustment needed to restore competitiveness (which UNCTAD estimated at only 10–15 per cent, instead of the very sharp currency drops that took place). However, “the use of high interest rates, the extent of currency devaluation and the reduction in growth rates that created conditions of debt deflation quickly acted on financial institutions and company balance sheets to create a solvency crisis”.

In other words, in this analysis, the crisis-stricken countries that sought IMF funds were never given a proper chance. What would that chance have looked like? According to *TDR.98*, given the sharp attacks on the currencies, the appropriate action would be to move quickly to solve the

problem by introducing a debt standstill and bringing the borrowers and lenders together to reschedule, even before the commitment of IMF funds. A combination of rapid debt restructuring and liquidity injection to support the currency and provide working capital for the economy would also have made it possible to pursue the kind of policies that enabled the United States to recover quickly from a situation of debt deflation and recession in the early 1990s. In the United States, reacting to the weakness in the financial system and the economy, short-term interest rates were reduced in the early 1990s to almost negative levels in real terms, thus providing relief not only for banks, but also for firms and households, which were able to refinance debt at substantially lower interest-servicing costs. This eventually produced a boom in the securities market, thereby lowering long-term interest rates and helping to restore balance sheet positions, thus providing a strong recovery. The policies pursued in the early 1990s were exemplary in the way they addressed debt deflation, making it possible for the US economy to enjoy one of the longest post-war recoveries.

UNCTAD's analysis thus shows the sharp contrast between the IMF's policy (which is influenced by the United States) of tight credit and high interest rates imposed on the affected Asian countries, as opposed to the United States' own policy of low interest rates and provision of liquidity.

In another interesting section, *TDR.98* (pp. 75–76) considers whether the Asian development model has been killed by the crisis. It notes the view of some Western commentators that blamed the crisis on the Asian countries' structural shortcomings (such as the close government-business relation and market distortions that insulated business from competitive forces and market discipline). However, while the East Asian economies are run differently from the Western model, its present crisis does not differ from similar crises experienced by developed and developing countries, including those operating under the Western Anglo-American model.

The Asian crisis "is yet another episode in a series of crises that have been occurring with increasing frequency since the breakdown of the Bretton Woods arrangements, and with the introduction of floating exchange rates and the unleashing of financial capital". As in the earlier episodes of financial crisis and currency turmoil in developing countries, the East Asian crisis "was preceded by financial liberalization and deregulation which, in some cases, constituted a major break with past practices. In this sense the fundamental problem was not that there was too much government intervention and control, but too little". *TDR.98* draws the lesson that successful industrialization depends on how profits and integration into the global economy are managed. The Asian crisis confirms this: "When policies falter in managing capital and integration, there is no limit to the damage that international finance can inflict on an economy". There is certainly considerable scope for national policies in preventing and better managing crises of this sort, but "these crises are a systemic problem, and action is therefore needed also at the global level" (UNCTAD, 1998: 76).

#### **D. Lack of mechanism for debtor-creditor burden sharing**

The latest bout of financial crises has again highlighted the absence of an international mechanism for the fair sharing of burden between creditor countries and debtor countries, and between international private creditors and domestic private debtors. In the absence of such a mechanism, unsatisfactory situations occur. In many cases, the creditors, being in a stronger position than a country facing default, can insist on full repayment, and with stringent terms of

rescheduling of debt payments, for example, higher interest rates or the government taking over (or guaranteeing) the debts of the country's private sector.

The creditors do not share fairly in the losses, while the debtor country has to assume all or most of the losses. This contrasts with a normal commercial situation, in which a financial institution giving credit shares in the loss should the borrowing company get into difficulties or goes into bankruptcy. Sometimes this kind of imbalanced "solution" is mediated by international agencies. In other cases, the situation drags on with the debtor country's government involved in prolonged bouts of negotiations with private creditor institutions, without a clear solution, leaving the country in a situation of continuous debt. Only in exceptional cases is a heavily indebted country in a position to declare a default and take the lead in announcing measures implementing its intention to only partially pay back its loans to foreign creditors and investors.

The lack of a systematic and fair method of settling debts in conditions of financial crises is a major disadvantage to developing countries as they are usually the debtors.

## **E. Lack of transparency and regulation of international financial markets**

The workings and movements in international financial markets have played the major role in financial crisis. There have been increasing calls from many quarters for reforms to these markets. Yet there is also a lack of transparency on what constitutes the financial markets, who the major players are, what moves and decisions they make, and to what effect. There are thus deficiencies in terms of the lack of transparency, information, monitoring and regulation of financial markets and the institutions that are major players in these markets.

## **F. Proposals**

### ***1. International-level proposals***

#### ***(a) Greater transparency and regulation of international financial markets***

There should be greater transparency in the way the financial markets operate. There should be more disclosure of the players and the deals in the various markets, including the trade in currencies. In particular, the funds available to and the operations of highly leveraged institutions such as hedge funds should be made public.

At the global level, there should be a system of monitoring short-term capital flows, tracing the activities of the major players and institutions, so that the sources and movements of speculative capital can be publicly made known.

There should be greater regulation of the behaviour and operations of financial institutions. A distinction should be made between legitimate forms of investment and speculation, and unethical methods of speculation and market manipulation. Regulatory measures should be taken to prevent, prohibit or control the latter.

There can be also be serious pursuit of a global tax on short-term financial flows, such as the Tobin Tax, where a small tax (say, 0.25 per cent) is imposed on all cross-country currency transactions. This will penalize short-term speculators while it will have only a very small effect on genuine traders and long-term investors. The advantage is that not only will speculation be discouraged, but there can be greater transparency in the markets as movements of capital can be more easily traced.

At the national level, in the North countries, which are the major sources of international capital flows and speculation, tighter national regulations can be introduced to curb excessive speculative activities. For example, banking regulations can be introduced to limit the amount and scope of credit to hedge funds.

*(b) Debt standstill and orderly debt workout*

Countries coming under speculative attack and who want to avoid an uncertain economic recession or collapse may have little choice but to resort to two presently unconventional measures – a “debt standstill” (or temporary stop in servicing external loans) and capital controls. This is a conclusion on the management and prevention of financial crises in the *TDR.98*. It reviews four lines of defence an indebted country can, theoretically, take if faced with a massive attack on its currency: domestic policies (especially monetary and interest rate policy) to restore market confidence and halt the run; maintaining sufficient foreign reserves and credit lines; use of an international lender-of-last resort facility to obtain the liquidity needed; and a unilateral debt standstill accompanied by foreign exchange restrictions, and initiation of negotiations for an orderly debt workout.

Although the first three are theoretically possible, in reality they either do not work or are not in existence. Therefore, the fourth option should be considered seriously.

Under this fourth option (debt standstill and workout), *TDR.98* (UNCTAD, 1998: 89–93) has proposed the setting up of an international insolvency procedure whereby a country unable to service its foreign debts can declare a standstill on payment and be allowed time to work out a restructuring of its loans, while creditors would agree to this “breathing space” instead of trying to enforce payment. This proposal is actually an extension of national bankruptcy procedures (similar to Chapter 11 of the United States Bankruptcy Code) to the international level for countries facing debt difficulties. Bankruptcy procedures are especially relevant to international debt crises resulting from liquidity problems as they are designed to address financial restructuring rather than liquidation. In an international system, one option is to set up an independent panel to determine if a country is justified in imposing exchange restrictions with the effect of debt standstills. The decision for standstill could be taken unilaterally by the debtor country, then submitted to the panel for approval within a period. This would avoid “inciting a panic” and be similar to safeguard provisions in the World Trade Organization allowing countries to take emergency actions. These debt standstills should be combined with debtor-in-possession financing so the debtor country can replenish its reserves and get working capital. This would mean the IMF “lending into arrears”. The IMF funds for such emergency lending would be much less than the scale of bailout operations. The IMF can also help arrange for private-sector loans with seniority status.

As regards government debt to private creditors, reorganization can be carried out through negotiations with creditors, with the IMF continuing to play an important role of bringing all



creditors to meet with the debtor government. For private sector debt, negotiations could be launched with private creditors immediately after the imposition of debt standstill.

The above proposal should be seriously pursued by developing countries. In the absence of such an international system, developing countries have been at the mercy of their foreign creditors and investors, who can suddenly pull out their funds in herd-like manner. Without protection, these countries first face a liquidity crisis which in turn produces a solvency crisis and then an economic crisis. If a Chapter 11 type of international bankruptcy procedure is in place, a country facing the imminent prospect of default can declare a debt standstill, get court clearance for protection from creditors, obtain fresh working capital, restructure its debts, and plan for economic recovery which in turn can eventually service the debts adequately.

With such procedures, countries facing a “cashflow problem” can nip it before it worsens and thus prevent a major crisis. Both the debtor country and its creditors gain. This would contrast with the present messy situation, where in the absence of a fair system, all creditors rush to exit the country, each hoping to recoup its loan before other creditors take out their loans. When the debtor country has its back to the wall, the creditors as a group usually demand, in a restructuring plan, that the government not only pay higher interest on its loans, but also take over or guarantee the payment of the loans contracted by private banks and firms.

*(c) International environment enabling the option of capital controls*

The international orthodoxy of recent years, that developing countries would obtain great benefits while having little risks in having a financially open system, is now losing credence in light of the extremely high costs being paid by several countries that opened up and experienced the sudden entry and exit of foreign funds, with the resulting instability and economic dislocation. A new paradigm is emerging that grants that developing countries should have and, indeed, should sometimes take the option of maintaining or imposing capital controls to protect their interests and to enable a degree of financial stability. Especially in the absence of international regulation of capital flows, capital controls should not be taboo but be seen as a normal, acceptable and, indeed, valuable component of the array of policy options available to promote development.

This emerging paradigm is one of the outcomes of the recent round of the financial crisis. In order for developing countries to be able to exercise this option, however, the present prejudices against such controls should be removed. For example, the IMF has been advocating capital account convertibility as a key financial policy for developing countries and has been against their adoption of capital controls, even in times of financial stress and crisis. Since the IMF has a strong influence on developing countries, and especially on those which are dependent on its loans, such a position constitutes a barrier to developing countries’ ability to exercise the option. Therefore, there should be a change in the international policy environment or framework, such that developing countries can adopt capital controls as part of their range of policies, without their being looked upon with disapproval by international agencies or the developed countries. Just as importantly, moves or measures taken at the international level to pressurize developing countries towards rapid financial openness (for example through adding capital account convertibility to the mandate of the IMF) should be reversed, if developing countries are to be able to choose the option of capital controls in a comfortable policy environment.

Capital controls are not a new measure but have, instead, been used by most countries until recently, and many nations still have them. *TDR.98* describes a wide range of capital controls that

have been or can be used, and for which purposes. It concludes that in the light of the Asian crisis and the current international financial turbulence, to protect themselves against international financial instability, developing countries need to have capital controls, since these constitute a proven technique for dealing with volatile capital flows. Several other measures (such as more disclosure of information, better banking regulation and good corporate governance) that have been proposed by the industrial countries and the IMF have merit but are inadequate to deal with the present and future crises. Developing countries should thus be allowed to introduce capital controls, as these are “an indispensable part of their armoury of measures for the purpose of protection against international financial instability”.

Control on capital flows are imposed for two reasons: firstly, as part of macroeconomic management (to reinforce or substitute for monetary and fiscal measures) and secondly to attain long-term national development goals (such as ensuring residents’ capital is locally invested or that certain types of activities are reserved for residents). Contrary to the belief that capital controls are rare, taboo or practised only by a few countries that are somehow “anti-market”, the reality is that these measures have been very widely used. In early post-war years, capital controls for macroeconomic reasons were generally imposed on outflows of funds as part of policies dealing with balance-of-payments difficulties and to avoid or reduce devaluations. Rich and poor countries alike also used controls on capital inflows for longer-term development reasons. When freer capital movements were allowed from the 1960s onwards, large capital inflows posed problems for rich countries such as Germany, Holland and Switzerland. They imposed controls such as limits on non-residents’ purchase of local debt securities and on bank deposits of non-residents. More recently, some developing countries facing problems due to large capital inflows also resorted to capital controls.

Controls on inflows of FDI and portfolio equity investment may take the form of licensing, ceilings on foreign equity participation in local firms, official permission for international equity issues, differential regulations applying to local and foreign firms regarding establishment and permissible operations. Controls on capital outflows can include controls over outward transactions for direct and portfolio equity investment by residents as well as foreigners.

Recent financial crises and frequent use of capital controls by countries to contain the effects of swings in capital flows point to the case for continuing to give governments the autonomy to control capital transactions. Ways have not yet been found to eliminate at the global level the cross-border transmission of financial shocks and crises due to global financial integration and capital movements. *TDR.98* thus concludes that, for the foreseeable future, countries must be allowed the flexibility to introduce capital control measures, instead of new obligations being imposed on these countries to further liberalize capital movements through them.

#### *(d) International management of exchange rates*

Since the end of the Bretton Woods fixed-exchange rate system, currencies have been fluctuating to a lesser or greater degree. In recent years, it has become more and more obvious that the volatility of changes in exchange rates has become a major problem. Given the wild swings of exchange rates in some currencies, it is not tenable to hold that currency movements are only reflections of changes in fundamental market values of these currencies. Instability of currency rates has become a major contributing factor to overall financial instability in affected countries and globally. As part of a reform of the international financial architecture, a more stable system of currency exchange rates needs to be established.

*(e) Responding to international pressures for further financial liberalization*

At least until the outbreak of the Asian crisis, there had been strong pressures emanating from international organizations for an international regime disciplining countries to open up their capital accounts, thus making the freedom of the flow of funds (including those that are not directly related to trade or FDI) a standard and obligatory policy. For example, there have been moves to amend the Articles of the IMF to incorporate capital account convertibility as part of its mandate. In the proposed multilateral agreement on investment that was negotiated within the OECD, one of the proposed clauses was the freedom of foreign investors and funds to transfer short-term capital into and out of signatory countries. Although the two initiatives have slowed down (in the case of IMF) or stalled (in the case of the OECD) at present, there could be a resumption of pressures to discipline developing countries to increasingly open their capital accounts. Such pressures should not be resumed, given the recent evidence of the possible negative effects of liberalizing the capital account by countries that were not yet prepared to withstand the potential shocks. While capital account liberalization may bring net benefits under some conditions, too little is still known about the appropriate ways to manage the capital account, especially for developing countries. Thus, countries should be allowed to choose their own policies without facing pressures either from international agencies or other countries to liberalize.

*(f) Reform of the framework for macroeconomic policy*

The set of macroeconomic policies that forms a key part of the so-called “Washington Consensus” (that puts the stress on “getting prices right”, withdrawal of the State from the economy and economic policy-making, heavy reliance on the free market, deregulation, privatization and liberalization, austerity budgets and high interest rates) has been at the centre of conditionalities attached to IMF and World Bank loans for indebted countries. These policies have come under heavy criticism, especially in the wake of the Asian crisis. The “one-size-fits-all” approach towards economic reform and policy for countries in financial crisis should be changed to a more appropriate approach of seeking the right mix of policies to suit the particular conditions facing each country. Such conditions may vary from country to country, and thus the policy mix may also be different for different cases. Thus, the framework for macroeconomic policy advice or conditionality should be reformed to take into account these differences, and in light of lessons to be learnt about which strategies have and have not worked in different circumstances. Countries must have the flexibility to choose from policy options, as it is not appropriate to present them with advice or conditions based on a single model or option.

## **2. National-level proposals**

*(a) Need for serious caution about financial liberalization and globalization*

One of the major lessons of the Asian crisis is the critical importance for developing countries to properly manage the interface between global developments and national policies, especially in planning a nation’s financial system and policy. While under certain conditions, liberalization can play and has played a positive role in development, the Asian crisis has shown up that in other circumstances, liberalization can wreak havoc. This is especially so in the field of financial liberalization, where the lifting of controls over capital flows can lead to such alarming results as a country accumulating a mountain of foreign debts within a few years, the sudden sharp depreciation of its currency, and a stampede of foreign-owned and local-owned funds out of the country in a few months.

It is thereby only prudent for a developing country to have measures that reduce its exposure to the risks of globalization and thus place limits on its degree of financial liberalization. Countries should not open up and deregulate their external finances and foreign exchange operations so rapidly when they are unprepared for the risks and negative consequences. Measures should be adopted to prevent speculative inflows and outflows of funds, and to prevent opportunities for speculation on their currencies.

At the least, the process of opening up to capital flows should be done at a very gradual pace, in line with the growth of knowledge and capacity locally on how to adequately handle the new processes and challenges that come with the different aspects of liberalization. This will require policy makers in all relevant departments to have the proper understanding of the processes at work, the policy instruments to deal with them, adequate regulatory, policy and legal frameworks and the enforcement capability. Moreover, the private sector players (including banks and other financial institutions, and private corporations) will also have to understand and master processes such as inflows of funds through loans and portfolio investment, the recycling of these to the right sectors and institutions for efficient use, and the handling of risks from changes in foreign currency rates.

The whole process of learning, training and placing the required infrastructure in place will need a long period. Some European countries, which started with already sophisticated financial systems, took more than a decade to prepare for liberalization, and yet failed to prevent financial failures.

*(b) Establishing a comprehensive national policy towards capital flows*

It is uncertain whether there will be any adequate reforms to the international financial system. Meanwhile, developing countries will still be subjected to volatile capital flows. It is thus imperative that developing countries establish a national policy framework to deal with international capital flows. In doing so, it would be useful to distinguish between the various types of foreign funds, and their impact on recipient countries. Following this, measures should be considered to manage these different types of capital flows.

One of the critical aspects to look at is the potential effect of different types of funds on foreign exchange reserves and the balance of payments. This is because in the present financially open system that most countries subscribe to, a country with inadequate foreign reserves or with a deteriorating balance of payments can begin to become seriously indebted, or be subjected to panic withdrawal of funds, speculative attacks and currency depreciation.

Foreign direct investment, portfolio investment, foreign loans and credit, and highly speculative funds are the major categories of foreign capital that flow in and out of a country. Since developing countries are too small to be a big player on the global market, they can be very vulnerable not only to the decisions of the big institutions that determine the volume and timing of the flows, but also to the manipulative activities of some of the global speculative players.

However, developing countries can take some defensive measures, and must formulate a comprehensive policy to deal with the different kinds of capital flows. Such a framework may include a selective policy towards attracting FDI of the right type; a careful policy on portfolio investment that welcomes serious long-term investors but discourages or prohibits the damaging

short-term profit-seekers; a very prudent policy towards public and private foreign loans; and measures that as far as possible avoid manipulative activities and institutions.

Even with the best intentions and plans, there is no certainty that a country can be shielded from the adverse turbulent effects of global capital flows and financial operations. The national policies have to be augmented by international regulatory action, which is still absent. Until that comes about, if ever, each nation should look out for itself.

*(c) Managing external debt*

External debt management should be top priority in a nation's economic policy, as excessive debt can lead not only to a heavy burden on national resources but even more seriously to the loss of policy autonomy and dependence on other countries or international institutions to formulate the nation's basic policies, and these externally made policies can be inappropriate and contribute to many years of economic and social deterioration.

Great care should be taken to limit the extent of a country's foreign debt to levels where it can be serviced with a margin of comfort. Developing countries should beware of the dangers of building up a large foreign debt (whether public or private debt), even if they have relatively large export earnings.

As the East Asian financial crisis showed, even countries that are big exporters, including of manufactured goods, should beware of believing that the export earnings would comfortably provide the cover for a rapid build up of external debt. High export earnings alone are insufficient to guarantee that debts can be serviced. For a start, future export growth can slow down. There can also be a high growth in imports and a large outflow of funds due to repatriation of foreign-owned profits or due to the withdrawal of short-term speculative funds. In good years these factors can be offset by large inflows of foreign long-term investment. However, if the negative factors outweigh the inflows, the balance of payments will register a deficit and contribute to the running down of foreign reserves. If a point is reached when the reserves are not large enough to pay for current debt servicing, the country has reached the brink of default and thus may have to declare a state of crisis requiring international assistance. In the affected Asian countries, their debt problems had been compounded greatly by the sharp depreciation of their currencies, thus raising equally sharply the burden of debt servicing in terms of each country's local currency, and making the situation impossible to sustain.

Thus, having a large foreign debt puts a country in a situation of considerable risk, especially when the country has financially liberalized, there is full capital mobility and its currency is fully convertible and thus subject to speculation. A cautious policy should be adopted not only for public-sector foreign debt but also private-sector bank and corporate debt. It would be a mistake to believe that if debt is contracted by the private sector, that would be safer than if the build up is by the public sector. As the Asian crisis showed, private firms and banks can make mistakes, even bigger ones, than governments, as much of the recent build-up of debt that became unrepayable was contracted by the private sector, in Indonesia, the Republic of Korea and Thailand.

In particular, having too much short-term debts can be dangerous as they have to be repaid within a short period, thus requiring the country to have large enough reserves at that period to service these debts. The structure of debt maturity should be spread out, keeping in mind the dangers of "bunching", or too much debt coming due at the same time. It is thus important to keep

a watch on the relation of levels of debt and debt servicing not only to export earnings but also to the level of foreign reserves. Reserves should if possible be built up to a level comfortable enough for a country to service its foreign debt, and especially short term debt.

*(d) Managing foreign reserves*

The careful management of foreign reserves has thus emerged as a high-priority policy objective, especially in the wake of the recent financial crisis. Maintaining or increasing foreign reserves to an adequate level is a difficult and complex task. There many factors involved, such as the movements in merchandise trade (exports and imports), the payment for trade services, the servicing of debt and repatriation of profits, the inflows and outflows of short-term funds, the level of FDI and the inflows of new foreign loans.

All these items are components of the balance of payments, whose “bottom line” (or overall balance, either as surplus or deficit) determines whether there is an increase or run-down of a country’s foreign reserves. These items are determined by factors such as the trends in merchandise trade, the external debt situation (in terms of loan servicing and new loans), the “confidence factor” (which affects the volatile movements of short-term capital as well as FDI). To these must now be added the state of the local currency which (in the absence of capital controls) cannot be assumed to be stable; its level and movement have become major independent factors that both influence the other factors and are in turn influenced by them.

To guard and build up the foreign reserves, the country has thus to take measures in the short and longer term to strengthen the its balance of payments, in particular the two main aspects, the current account and the capital account. The first aspect is to ensure the current account (which measures movements of funds related to trade and services) is not running a high deficit. The second aspect is to build up conditions so that the capital account (which measures flows of long and short-term capital not directly related to trade) is also manageable and well behaved. These goals can be difficult to achieve especially in the present volatile circumstances.

*(e) National capital controls*

It was earlier argued that an international policy environment is needed that treats the use of capital controls as a normal part of national financial policy with the aims of shielding the country from the turbulence of potential volatile flows of funds, and of having greater stability in the exchange rate. With a more sympathetic international environment, developing countries can then feel comfortable with using the option of selectively maintaining capital controls to regulate the inflow and outflow of funds. Some details of the use of capital controls have been given in the earlier section on international proposals. Further examples are given below.

To avoid excessive inflows or undesirable types of funds, various regulations can be introduced. For example, in Malaysia, there is a Central Bank ruling that private companies have to seek its permission before taking foreign loans, which will be given only if it can be shown that the projects can earn foreign exchange to finance debt servicing. Such a rule helped Malaysia from building up the high levels of private foreign debt that had developed and led to the crisis in Indonesia, the Republic of Korea and Thailand. There can also be regulations limiting foreign portfolio investment and that limits speculative behaviour in the stock exchange; that constrain currency speculation (for example by limiting the amount of local currency loans to foreigners), and that prohibit the international trade in the local currency. Regulations on capital outflows could

include the prohibition of locals opening overseas bank accounts, limiting the types and amounts of transfers to abroad, and constraining the overseas investments of local companies. The regulations can be varied or removed according to changing circumstances and developments.

Some of these measures were adopted recently in Malaysia as part of its response to the financial crisis. Another of its major measures was the fixing of the local currency to the US dollar. The package of measures is credited with helping the country to deal with the crisis and initiate a recovery process.

*(f) Managing the exchange rate*

The management of the exchange rate, to enable stability, is one of the major challenges now facing developing countries. In a review of different systems of exchange rate management (from freely floating and pegged rates to Currency Board fixed-rate and dollarization systems), *TDR.99* has concluded that the key to having reasonable exchange rate stability is the regulation of destabilizing capital flows. Under free capital mobility, no regime of exchange rates will guarantee stable and competitive rates, nor will it combine steady growth with financial stability. "Differences among systems of pegged, floating and fixed exchange rates lie not so much in the extent to which they can prevent volatility of capital flows or contain their damage to the real economy as in how the damage is inflicted. Damage can only be prevented or limited if there is effective regulation and control over destabilizing capital flows. While that may not be without cost, the cost is likely to be small compared to that of currency instability and misalignment and financial crises. Managing nominal exchange rates in a flexible manner in order to minimize fluctuations in the real exchange rate, in combination with controls on destabilizing capital flows, thus remains the most plausible option for most developing countries" (UNCTAD, 1999a: 130).

## **IV. ISSUES IN INVESTMENT LIBERALIZATION**

### **A. Introduction**

Recent increased interest on the issue of investment liberalization and the desirability or otherwise of an international framework on investment policy and rules has been sparked by the proposal of the developed countries to introduce a legally-binding international regime on foreign investment. This proposal had emerged in a number of forums and especially at the OECD and the WTO.

Within the OECD, a Multilateral Agreement on Investment (MAI) was the subject of intense negotiations by its member countries. It was the intention that OECD countries would first sign the MAI and then the treaty would be opened to developing countries to accede to. However, the MAI negotiations have stopped, after protests by civil society and disagreement among the OECD members.

On a separate track, in the WTO, some developed countries in 1995 and 1996 also proposed negotiations towards a multilateral investment agreement (MIA). It was proposed that WTO general principles relating to trade (including reduction and removal of cross-border barriers, national treatment, most-favoured nation treatment) as well as the integrated dispute settlement

system (which enables retaliation and cross-sectoral retaliation) would now be applied also to investment. Many developing countries had objected to the issue of investment per se being brought onto the agenda of the 1996 WTO Ministerial Conference. However, discussion did take place in Singapore, and a decision was taken to establish a working group to examine the relation between trade and investment. This was meant to be only an educative process for an initial two-year period and any decision to have negotiations for an agreement would have to be taken only on the basis of explicit consensus. In 1999, several developed countries led by the European Union were advocating that the investment issue be included in a proposed new Round of multilateral trade negotiations to be launched at the WTO Ministerial Conference in Seattle in November/December 1999. However, several developing countries voiced the view that the “study process” in the WTO working group should continue for some more years and that there should not be negotiations for an investment agreement, at least not at this stage. With the collapse of the Seattle meeting, there is at present no programme for negotiations for an investment agreement in the WTO and the Working Group will presumably resume its study process.

A reading of the draft text of the MAI in the OECD and the European Commission’s 1995 paper on “A level playing field for FDI worldwide” shows that the MAI and the EC vision of an investment agreement in the WTO were basically similar in objectives and content. Both aimed at protecting and advancing the rights of international investors vis-à-vis host governments and countries. The main elements include the right of entry and establishment of foreign investors and investments; the right to full equity ownership; national treatment; the right to free transfer of funds and full profit repatriation; protection of property from expropriation; and other accompanying measures such as national treatment rights in privatization. A more recent EU paper at the WTO has proposed a more “dilute” version of an investment agreement in the WTO, with a “positive list” approach, in which members may list the sectors for liberalization and the extent of liberalization, and where the scope would be limited to FDI (unlike the OECD-MAI’s broad scope that included all kinds of foreign capital). There is no doubt, however, that even the diluted proposal is aimed at increasing the pressure on developing countries to liberalize their foreign investment rules and to extend national treatment privileges to foreign investors.

These pressures have increased the need for developing countries to examine the nature of foreign investment and review appropriate policies for managing foreign investment.

## **B. The benefits and risks of foreign investment**

There has been a significant increase in foreign investment, including to developing countries, in recent years. Since the early 1990s, FDI flows to developing countries have risen relatively, averaging 32 per cent of the total in 1991–1995 compared with 17 per cent in 1981–1990. This coincides with the recent liberalization of foreign investment policies in most developing countries. However, again, there is a high concentration of these FDI flows to developing countries: much of the FDI is centred in only a few countries. LDCs in particular are receiving only very small FDI flows, despite having liberalized their policies. Thus, FDI is insignificant as a source of external finance to most developing countries, and is likely to remain so in the next several years.

The last few decades have also witnessed a significant shift of perspective in many developing countries towards foreign investment. In the 1960s and 1970s there was considerable reservations and mistrust by governments of many developing countries, as well as many



development economists towards foreign investment. Starting with the 1980s, however, there has been a growing tendency for viewing foreign investment more positively. A new orthodoxy came into being, that as a form of foreign capital, investments were superior to loans because the investments (unlike loans) would not land the host country into a debt crisis. Indeed foreign investment is being seen as a panacea for removing the obstacles to development.

Just as originally the view of many may have been extremely unfavourable to foreign investment, the pendulum could have swung to the other extreme to the extent that some now view foreign investment as an mixed blessing. In reality, there are benefits and costs accompanying foreign investment. The task for policy makers and analysts alike is to ascertain the determinants of the benefits and costs, and attempt to devise policies to increase the benefits and reduce the costs, with the aim of ensuring that there be net benefits.

This is especially so when little seems to be known of the effects of investment liberalization. At an OECD-organized workshop on FDI and the MAI in Hong Kong (China) in March 1996, the keynote speaker, Dr. Stephen Guisinger of University of Texas, said that “Very little is known about repercussions of foreign direct investment liberalization on host economies...The link between investment liberalization and macroeconomic performance has received scant attention from researchers”.

Studies by the Malaysian economist Ghazali bin Atan (Ghazali 1996, 1990) on the effects of FDI on savings, financial inflows and outflows, trade and growth conclude that successful growth in developing countries is premised essentially on raising the domestic savings rate to a high level and productively investing the savings. This is more important than the role of foreign capital, including FDI. The East Asian growth success is based mainly on high domestic savings rather than FDI. Foreign capital can help to supplement domestic savings but this has its downside. There are three types of foreign capital inflow: aid, debt and FDI. Foreign direct investment has many advantages (bringing in productive capital, foreign expertise, brand names, market linkages, aiding in industrialization, exports, employment).

However, there are also disadvantages or costs to FDI. These impacts need to be managed to ensure a net positive outcome. The study found that FDI has a negative effect on domestic savings, as it gives room for the recipient country to increase its consumption. FDI generates positive and negative effects on the flow of foreign exchange on two accounts: financial and trade. On the financial side, FDI brings in capital, but also leads to a stream of outflows of profit and other investment income. This outflow increases through time as the stock of foreign capital rises. Thus, FDI has a tendency to lead to “decapitalization”. Comparing aid, debt and FDI, the study finds that because of the much higher rate of return of FDI compared to the rate of interest paid on aid or debt, the “decapitalization” effect of FDI is greater than of aid or debt.

On the trade side, FDI has a positive effect through higher export earnings and a savings on imports (for products locally produced), but a negative effect through higher imports of intermediate and capital goods. It may also have a negative effect in raising imports of consumption goods. In many cases, FDI is heavily reliant on large imports of capital and intermediate goods. The high import content reduces the positive trade effect. Ghazali’s study shows that generally there is a weak positive trade effect from FDI, and in some cases a negative trade effect. In order for FDI to have a positive effect on balance of payments, there must be a strong enough positive trade effect to offset the negative decapitalization effect. However, due to the weak positive trade effect, or even a negative trade effect in some cases, there is a tendency for FDI to cause a negative

overall effect on the balance of payments. Without careful policy planning, the negative effect could grow through time and be serious as profit outflow builds up.

Moreover, too rapid a buildup of FDI could also lead to “de-nationalization”, where the foreign share of the nation’s wealth stock increases relative to local share. To avoid economic or social problems that this may cause, Ghazali proposes that the rate of growth of domestic investment should exceed FDI growth.

Regarding the effect of FDI on economic growth, there are direct effects (which are generally positive) and indirect effects (which are generally negative, due mainly to the decapitalization effect). While the inflow of new FDI exerts a positive effect, the outflow of investment income arising from the accumulated foreign capital stock exerts a negative effect.

Given the various ways in which FDI affects the host economy, Ghazali (1996: 8–9) proposes that for FDI to be used successfully (with net overall benefit), the following conditions should be met:

- (i) Availability of foreign capital does not detract from own savings effort;
- (ii) The factor payment cost must be minimized and prudently managed;
- (iii) Encourage or require joint ventures so that part of the returns accrue to locals and is retained by the local economy;
- (iv) Get foreign firms to list themselves on local bourses;
- (v) To enhance positive trade effects, FDI must be concentrated in the tradable sector, especially in export-based activities;
- (vi) Local content of output should be raised over time to improve trade effect;
- (vii) The growth of domestic investment should exceed FDI growth;
- (viii) To avoid reliance on foreign capital, developing countries should increase their savings rate and maintain sound economic and political conditions.

Ghazali’s conclusions are that: “The above are among preconditions for ensuring successful use of FDI. Countries using FDI without regard to the above conditions would do so at their own peril. Any moves designed to prevent host countries from instituting such policies, however they are couched, are moves designed to keep developing countries at the bottom of the global economic ladder ... With the correct policies, FDI can be of great help to host countries. Without the correct policies, however, the use of FDI can lead to severe problems especially with regard to the long-term viability of the recipient’s balance of payments”.

Several other recent studies have come to similar conclusions on the benefits and costs of FDI and the need for a regulatory policy framework.

In a survey of the effects on FDI on development, *TDR.97* (pp. 91–98) and *TDR.99* (pp. 115–123) differentiate between different types of FDI, discusses its potential for causing financial

instability and assesses its impact on the balance of payments. *TDR.99* estimates that mergers and acquisitions form half to two thirds of world FDI flows in the 1990s. For developing countries, excepting China, the recent FDI boom has consisted predominantly of M&A, its share of total FDI to developing countries being 72 per cent in 1988–1991. Thus, much of FDI to developing countries is not in the form of “greenfield investment” which creates new productive assets, but consists of the purchase of existing assets, especially through privatization and in the services sector.

*TDR.97* shows that contrary to its image of being a source of stable funding, FDI can also be a source of considerable financial instability. Even when FDI is governed by long-term considerations, aggregate FDI flows can respond rapidly to changes in short-term economic conditions. Retained earnings (or profit re-investment) is a major form of FDI, and some of these are invested in financial assets rather than physical assets. Changes in the rate and volume of reinvestment can result in fluctuations and instability of FDI flows to a country. Moreover, as pointed out by a World Bank study, a foreign direct investor can borrow funds locally in order to export capital. And thereby generate rapid capital outflows; thus, it need not be the case that FDI is more stable than other forms of capital inflow.

On FDI’s balance of payments impact, *TDR.99* (like Ghazali) also distinguishes two types of effects: net transfers (which compares FDI inflows with associated payments abroad such as profits, royalties and license fees); and the trade effect (comparing exports from FDI and imports associated with FDI). Examining three case studies, it finds that in Malaysia the activities of foreign firms had a negative impact on both the net transfers and the trade balance in the 1980s and early 1990s. Similarly, in Thailand FDI had a negative net impact on the trade balance in the late 1980s and early 1990s on top of rising payments abroad for profits and royalties and these features of FDI contributed to external imbalances that played an important role in the country’s subsequent crisis. For Brazil, the ECLAC secretariat has warned that “in the near future there will be a significant deterioration in the balance of payments of transnational corporations in the Brazilian economy”. This is due to a trend of increasing remittances, rising concentration of FDI in the non-tradeable sectors, and the exhaustion of privatization-linked FDI.

The report also notes a worrying trend: there is a decreased association between FDI and export growth in developing countries. It quotes the conclusion of the Bank for International Settlements that for South and East Asian countries, there was a significant weakening of the relation between FDI and export growth in the 1990s (as compared to the 1980s) and this was a factor contributing to the payments problems and the crisis in East Asia. UNCTAD’s own data for a larger number of countries shows this weakening of the link between FDI and exports is widespread in the developing world. The same FDI inflows were associated with less rapid export growth in 1991–1996 than during 1985–1990. A major factor was the increasing concentration of FDI in services sectors, which do not yield much export earnings (UNCTAD, 1999a: 123).

In a study on FDI and development, the South Centre (1997) lists the possible benefits of FDI as technology transfer; increased production efficiency due to competition from multinationals; improvement in quality of production factors such as management (including in other firms); benefits to the balance of payments through inflow of investment funds; increases in exports; increases in savings and investments and hence faster growth of output and employment.

The acknowledged costs include the possible negative effects on the balance of payments due to increased imported inputs and profits to abroad; the high market power of multinationals can

lead to non-competitive pricing and its resulting overall inefficiency in resource allocation; adverse impact on competitive environment; discouragement of development of technical know-how by local firms. If it fails to generate adequate linkages with the local economy, FDI will have fewer spillover beneficial effects and may on balance be harmful if the other negative features above exist. Other costs are transfer pricing (which diminishes host government taxes); distortion of consumption patterns due to brand names of multinationals (with costly effects when costly foreign foods from FDI supplant local and more nutritious foods in the diet of the urban poor); the net loss of jobs when capital-intensive FDI displaces labour-intensive local firms.

There are also environmental and natural resource costs associated with FDI, and the risk of FDI in the media facilitating western cultural hegemony. Also, politico-strategic interests are at stake if FDI comprises a large component of total investment and involves loss of local control over strategic sectors, infrastructure and natural resources; while decisions made abroad can impact on the local economy and society, and sometimes even the country's sovereignty may be at stake. These factors have to be taken into account in an overall net evaluation of the costs and benefits of FDI.

Although there are arguments encouraging any kind or volume of FDI, the study concludes that an undiscerning policy towards FDI may cause serious long-run economic difficulties, harming a country's development prospects. Not all FDI is conducive to development, some kinds may do more harm than good, and a country that has a policy to accept any and all FDI may harbour trouble for future development prospects. To limit the risks and avoid undesirable effects, the study recommends governments to take a selective policy to FDI by determining the composition of capital inflows and intervening to manage inflows of capital including FDI; a selective policy with respect to specific projects, eg confining FDI to priority sectors; and prudence with respect to total FDI flows and stock to avoid more financial fragility. It concludes: "A global investment regime that took away a developing country's ability to select among FDI projects would hinder development and prejudice economic stability".

### **C. Regulation of and policy options on FDI**

The major issue of the desirability of a global investment regime is not whether or not foreign investment is good or bad or should be welcomed. It is whether or not national governments should retain the right and powers to regulate FDI and to have the adequate authority and means to have policy instruments and options over investment, including foreign investment. Most countries presently accept the importance of foreign investment and are trying their best to attract foreign investments. However, there is evidence that foreign investment can have both positive and negative effects, and a major objective of development policy is to maximize the positive aspects while minimizing the negative aspects, so that on balance there is a significant benefit.

Experience shows that for foreign investment to play a positive role, government must have the right and powers to regulate their entry, terms of conditions and operations.

### ***1. Regulations on entry and establishment***

Most developing countries now have policies that regulate the entry of foreign firms, and include various conditions and restrictions for foreign investors overall and on a sector-by-sector basis. There are few developing countries (if any) that has now adopted a total right of entry policy. In some countries, foreign companies are not allowed to operate in certain sectors, for instance banking, insurance or telecommunications. In sectors where they are allowed, foreign companies have to apply for permission to establish themselves, and if approval is given it often comes with conditions.

An international investment regime that grants the right to establishment and national treatment to foreign investors would put pressure on developing countries to give up or phase out present policies regulating the entry and the degree and conditions of participation of foreign investors.

### ***2. Policies favouring local firms and domestic economy***

Many developing countries also have policies that favour the growth of local companies. For instance, there may be tax breaks for a local company not available to foreign companies; local banks may be given greater scope of business than foreign banks; only local institutions are eligible for research and development grants; local firms may be given preference in government business or contracts.

Governments justify such policies and conditions on the grounds of sovereignty (that a country's population has to have control over at least a minimal but significant part of its own economy) or national development (that local firms need to be given a "handicap" or special treatment at least for some time so that they can be in a position to compete with more powerful and better endowed foreign companies).

Most developing countries would argue that during the colonial era, their economies were shaped to the advantage of foreign companies and financial institutions. Local people and enterprises were therefore at a disadvantage, and require a considerable time where special treatment is accorded to them, before they can compete on more balanced terms with the bigger foreign companies.

### ***3. Measures to manage the balance of payments***

As shown earlier, there is a general tendency for FDI to generate a net outflow of foreign exchange. Many developing countries have taken measures to try to ensure a more positive result from FDI on the balance of payments and on the domestic economy. These measures may aim at: (a) increasing the share of export earnings (and thus foreign exchange) in the output of FDI (for example, incentives or permission for higher equity ownership are given to firms that are more export-oriented in order to encourage export earnings); (b) reducing the imports of capital and intermediate goods by foreign firms through encouraging the use of local products; (c) reducing the amount of foreign profits through requirements that the foreign firm forms a joint venture with local partners, or allocates a part of the company's shares to locals, so that a portion of FDI profits accrue to locals; (d) requiring or encouraging a foreign firm to retain a significant part of their profits for reinvestment. The objectives are to generate spin-offs for and linkages to the domestic economy and thus boost growth, while also to attempt to get FDI to have a more positive impact

on the balance of payments by increasing the share of revenue and value-added that is retained in the economy.

Some of the traditional measures have already come under pressure from the WTO's TRIMS Agreement. Proposals for an investment agreement that prohibits a wide range of "performance requirements" (including the above but expanding the list to many new items) would make the situation even more difficult.

#### **D. Critique of attempts at international investment agreements**

The proposals for a multilateral agreement investment, either at the OECD or the WTO, seek to radically broaden the scope of freedom of movement and operation of foreign investors and their investments, and to provide more rights for them. Correspondingly it would severely narrow and restrict the rights and powers of States to regulate the entry, establishment and operations of foreign companies and their investments. It also makes host developing countries greatly more susceptible to legal action by foreign investors and their home governments due to strict dispute settlement procedures. There would be serious consequences of such an agreement for developing countries.

Firstly, it is unlikely that the claimed benefits will be realized by most developing countries. Its proponents claim that an investment agreement would lead to a greater flow of foreign investments to developing countries that join it, and that this is an indispensable condition for their development as it would spur economic growth. The main assumption is that foreign investment and its free movement only generates benefits for the host country, and does not result in costs, and that thus any increase will necessarily contribute to development. This assumption cannot be empirically supported.

Given these complex realities, it is obvious that foreign investment has to be prudently and well managed, so that the benefits are well brought out and the costs reduced, and that the former exceeds the latter. As this will happen only under certain conditions, the policy makers in the host developing countries need an array of policy instruments in an attempt to achieve net positive results. In the past and presently these instruments have included careful screening of investments and various conditions imposed on approved investments, a wide range of performance requirements (including technology transfer, establishment of joint ventures, local content), and controls on capital inflows and outflows (especially on loans and short-term capital). It is precisely these policy instruments that the proposed investment agreement is aiming to dismantle and make illegal. This would deprive developing countries of the opportunity or even the possibility of ensuring net benefits from foreign investment, and ironically (despite its preamble) it would more than tilt the balance so that foreign investment would probably result in costs outweighing the benefits in many cases.

But even if a country is willing to take the risks of increased and unregulated inflows, there is no guarantee (and in many cases no likelihood) that there will be an increase in foreign investment. The flow of foreign investment is determined by many factors, of which the treatment and protection of investment is only one factor, and usually not the most significant. Other factors are the opportunities for sales and profits, the size of the market, the general level of development of a country, the state of the infrastructure and quality of labour skills, political and social stability, the availability of natural resources to exploit, the location of the country. A developing country

that joins the investment agreement but does not possess some or most of the above qualities is likely not to experience an increase in foreign investment. Many countries that liberalized their foreign investment regimes under structural adjustment programmes have not seen a rise in foreign investment inflow.

Indeed, it is likely that the least developed countries would be at most disadvantage. More advanced developing countries have more of the attractive qualities (profitable market, infrastructure, skilled labour). An LDC can offset its lack of attractiveness by offering better treatment, protection or incentives. But if most or all developing countries were to join the MAI, then the LDCs would lose this advantage.

An MAI-type investment agreement would also potentially cause the following effects on developing countries: significant loss of policy autonomy over investment matters; erosion of sovereignty (including over natural resources) and of local ownership and participation in the national economy; and negative effects on the national financial position (Khor, 1999).

## **E. An alternative approach**

The initiatives on the MAI are of course not the first attempts at establishing an international framework on foreign investment. However, the approach taken by the MAI proponents is new in that it is an extreme and one-sided approach as it covers and greatly expands the rights of international investors, while not recognizing and thus greatly reducing the authority and rights of host governments and countries.

This one-sided approach on behalf of foreign investors' interests is in contrast to some earlier attempts within the UN system to set up an international framework on foreign investments that attempted to balance the rights and obligations of foreign investors and host countries, as well as to balance the foreign investors' production activities with development, social, environmental goals.

On a general level, the most well known has been the Draft UN Code of Conduct on Transnational Corporations, which underwent a decade of negotiations from 1982 to the early 1990s under the UN Commission on Transnational Corporations, and serviced by the UN Centre on Transnational Corporations (UNCTC, 1990).

The Code was an attempt at balancing the rights of host countries with the rights of foreign investors, and the obligations of TNCs with the obligations of host countries. The Code was also inclusive of many issues, including political dimensions (respect for national sovereignty, non-interference and human rights), development dimensions (transfer pricing, balance of payments, technology transfer) and social dimensions (socio-cultural values, consumer and environmental protection). The Code was placed in the context of international cooperation, recognized both the contributions and negative effects of TNCs, and sought to maximize the former and minimize the latter, towards the goal of development and growth. This is a more balanced approach than the MAI which implicitly only makes claims for the benefits of liberalizing and protecting foreign investments, and does not recognize or attempt to deal with the negative aspects.

The draft Code recognized both the rights of the host countries and the right of TNCs to fair and equitable treatment.

The Code and the MAI are obviously the products of contrasting paradigms. The Code arose from the perception that the host developing countries, while having to accord some rights to TNCs, required an international understanding that TNCs have to comply with international guidelines that recognize the countries' development needs and national objectives, and that the hosts could by right allow the guest foreign investors to enter and operate on terms generally chosen by the hosts. The MAI-type agreement on the other hand has arisen from the perceived need by foreign investors to expand and protect their interests from the perceived interference by States that impose conditions on their operations. In this paradigm, the "borderless world" is the ideal construct, and any barriers to the free flow of investments and to the right to investment, property ownership and unhindered operations must be considered "distortions" and the denial of the investors' rights. The affirmation of these alleged investors' rights are seen as important to prevent States from constraining the expansionary reach and operations of foreign investors.

The aborted Code of Conduct on TNCs was the main set of international guidelines that were to have dealt generally with the relations between TNCs or foreign investors with States. However, there are a number of other codes and guidelines that the UN system has established or attempted to establish that cover more specific issues.

These include the UNCTAD-based Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (adopted in 1980 by the UN General Assembly) and the Draft International Code of Conduct on the Transfer of Technology (which has not yet been adopted by the General Assembly); the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (1977); the WHO-based International Code of Marketing of Breast-Milk Substitutes (1981); and the Guidelines for Consumer Protection (based on a UN General Assembly resolution in 1985). In the environmental field, there are also international legal agreements (such as the Basel Convention banning the export of hazardous wastes to developing countries) that have an influence on the behaviour of international companies.

These instruments have the intention of influencing the behaviour of foreign investors and TNCs so that they conform to development needs, or fulfil social and environmental obligations. Together they would also constitute elements of an alternative approach to an international policy or framework on foreign investment. Such a framework, encompassing the various existing instruments, could be further developed through additional instruments covering other areas by sector and issue.

The recent history of evolving an international framework for foreign investment shows that the proposed MAI (and models based on it) constitutes only one approach. It is an approach based on a paradigm that seeks to protect foreign investors' rights to the exclusion of their obligations and of host countries' rights. A alternative approach would take into account the rights and obligations of host countries and foreign investors, ensure that these are properly balanced, and be based on the primary objective of contributing to economic development and social and environmental objectives. It is, however, an issue for debate whether such an approach is possible in the present global environment, and also what would constitute an appropriate venue for discussions on the investment issue.



## **F. Proposals for appropriate management of foreign investment**

### *1. Summary of conclusions*

Previous sections have emphasized the following points:

- (i) There are various categories of foreign investment, and it is important for governments to distinguish between the different types, understand the characteristics and effects of each type, and formulate policies to deal with each.
- (ii) Even in the apparently most beneficial type, FDI, where there can be important contributions to development of host countries, it is academically recognized that there are also potential costs and risks, among the most important of which are financial instability and balance-of-payments difficulties.
- (iii) Therefore a policy framework for managing FDI must take into account the need to attempt to maximize the benefits while reducing the costs and risks.
- (iv) Thus, governments, especially of the developing countries, because of their greater vulnerability, need to be able to formulate policies that: (a) distinguish between the types of FDI that are appropriate; (b) encourage the entry of FDI considered desirable, while discouraging or disallowing FDI considered not so appropriate to the country; (c) impose certain conditions, if found necessary, on the operations of FDI; (d) subject FDI policy to the wider national objectives and development needs.
- (v) The MAI approach is too one-sided in its objectives and functions of protecting and furthering foreign investors' interests while denying the interests of host States and countries. Moreover, there is the assumption that there is no need to distinguish between different types of foreign investment, that all foreign investments bring only benefits but no costs, and the articles of the MAI are therefore drawn up under assumptions. Social, cultural, development, environmental and human rights concerns are also ignored in this approach.
- (vi) There have been other attempts at creating international frameworks dealing with foreign investments or the behaviour of foreign enterprises. Some of these have been more accommodating to the rights and needs of host developing countries and to the imperatives of development. It would be useful to revisit some of these attempts and to examine the usefulness of reviving, improving or extending them, as well as to examine new approaches.

Given the above conclusions, this section attempts to provide suggestions for elements of an appropriate approach or framework for the management of foreign investment. Proposals will be confined mainly to FDI. The proposals are categorized as national-level and international-level approaches and actions.

## **2. National-level policies and actions**

### *(a) Selective policy on and strategic approach to FDI*

In view of empirical evidence on the benefits and costs of FDI, developing countries should have a selective policy and strategic approach towards FDI. The right of entry and establishment should thus be conferred by a State on to chosen foreign investors, and not be taken as inherent rights of the investors. Historically, many presently developed countries and the more advanced developing countries had such a selective policy. For example, Japan and the Republic of Korea had very little FDI (in 1984–1994, FDI inflows to Japan were less than one-tenth of one per cent of gross domestic capital formation), and the Republic of Korea and Taiwan Province of China had important restrictions on FDI entry and degree of foreign ownership. Yet these countries are among the fastest growing in the world. China and Malaysia have allowed much more FDI but they also have a selective approach in terms of opening up of certain sectors where foreign firms can contribute to technological and export development while discouraging FDI in other sectors where domestic companies are either weak (and need protection) or already possess technical capability (as in agriculture).

### *(b) Need to distinguish between the differing capacities and needs of local and foreign investors*

An indiscriminate policy of opening up and of treating foreign firms on equal or better terms than local firms could lead to deindustrialization in a country where the local enterprises are too weak to compete on equal terms with foreign firms. Thus, developing countries should be allowed to continue to protect certain sectors or industries where there is considerable local investment (or where the State is encouraging the attempting to build up local capacity).

In principle, State assistance to local enterprises should not be looked at as a “distortion”, or necessarily wasteful or somehow unethical, but possibly as legitimate affirmative action to help the weak companies to eventually stand on their own. There are advantages to national development for local enterprise or farm development to occur, since institutions belonging to nationals are more likely to make use of local materials and talents, generate more domestic linkages, and to retain profits locally for reinvestment, all of which are positive for economic growth and development.

Thus, a blanket “national treatment” policy towards foreign investment is inadvisable as a “level playing field” for local and foreign investors is likely to result in more unequal results when the capacities are unequal, as foreign investors are larger and starting from a much stronger position.

### *(c) Need to ensure acceptable treatment of investors*

In order to obtain FDI that is considered beneficial for national development, developing countries have to establish conditions that are attractive to foreign firms. This may include guarantees for their unhindered operations, the exercise of expropriation only in extreme circumstances and even then with adequate compensation at rates that can in principle be worked out before (so that the investor knows what the terms are), and freedom to remit profits generated from FDI. Other, and perhaps more important, conditions include political and social stability, security, good infrastructure, a credible legal system with due process, a trained or trainable labour

force, tax and other incentives, etc. Each country should, however, be given the space to determine which are the elements it chooses to adopt and act on.

*(d) Social and environmental screening and obligations of foreign investors*

Although developing countries may exert great efforts to attract the investors they desire, their right to request that foreign investors fulfil certain obligations and thus follow some conditions should be recognized. These may include the transfer of technology; the training and employment of local workers, professionals and executives; the development of linkages to the domestic sectors; providing local participation or partnership in equity ownership.

In light of a country's social and environmental goals and the need to maintain or raise standards, governments should carefully screen foreign investment applications and discourage or reject those projects or enterprises that would be socially or culturally detrimental (for example resulting in net loss of jobs, or endangering health and safety of workers or consumers, promoting unsustainable consumption patterns and lifestyles or adversely affect local cultural norms) or that would damage or pollute the environment (for example, through exploitation of natural resources that should be conserved; use of harmful technology or introduction of products that endanger consumer safety).

As part of the processes of application, selection and approval, foreign investments should undergo an environmental impact assessment and a social impact assessment and only those that are positively assessed should be approved, and with conditions if necessary. Moreover, foreign investors may be asked not only to operate with respect for domestic laws, but also to positively contribute to social and environmental development.

*(e) Assessing the effects on the local sectors and economy*

In their FDI selection system, developing countries should include an assessment of the effects of the proposed investment on the local economy, especially the local enterprises, farms and informal sector. For example, positive criteria for projects under application could include that the projects do not compete with existing local enterprises or farms, that contribute new appropriate technologies and that will have significant linkages with the domestic economy; while adverse factors could include significant displacement of existing local firms accompanied by loss of jobs, heavy dependence on imported inputs with little demand for local resources or locally produced inputs, and substitution of existing appropriate local products with inappropriate new products (e.g. expensive non-nutritious fast foods potentially replacing more nutritious local foods).

*(f) Protecting financial stability and the balance of payments*

Most importantly, in formulating their FDI policies, governments of developing countries should take into account the need protect their economies from the risks of financial instability and of getting into balance of payments or foreign exchange difficulties. Thus, foreign investors and their proposed projects should be carefully assessed as to the possible effects their activities would have on the nation's financial stability, foreign exchange position and balance of payments.

### **3. *International-level policies and actions***

#### *(a) Need for a fresh look at the nature and effects of foreign investments*

The nature and effects of cross-border foreign investments as a whole should be reviewed from an overall and balanced perspective. Just as the claims about the unalloyed positive effects of short-term capital have been brought down to earth by the Asian financial crisis, it is possible that events will in future also show up that the positive aspects of FDI are also matched by some negative effects.

It is thus important that a comprehensive review be made of the nature and the positive and negative effects of all kinds of foreign investment, and of the conditions for the successful use and management of each. Such a comprehensive and balanced approach is especially needed now as the global financial crisis has left in its wake a desperate search for causes, solutions, and correct policies.

#### *(b) Reconsideration of an appropriate international approach to foreign investment and investors' rights*

Given the inadequacies of theory and policies shown up by the financial and economic crises, it is timely for a reconsideration of international approaches to international investment. There should not be a continued "rush forward" with international policies and especially legally binding agreements that "lock" the vulnerable developing countries into a process of capital and investment liberalization under a MAI or MAI-type model of international arrangements on investment.

The global financial and economic crisis which is significantly related to cross-border capital flows signifies a new circumstance that calls for a deep study of and reassessment of recent trends in thinking on the nature of international capital movements. The next few years therefore should be devoted by the international community to an educative process on a wide range of investment issues. Until such a study process yields adequate insights to enable policy conclusions, there should not be initiatives to negotiate or promote a legally binding international agreement furthering the rights of foreign investors in areas such as their movement and establishment, national treatment and compensation. In particular, there should not be any further initiatives for furthering international arrangements which constrict or deny the host States of their rights or capacity to determine the role of foreign investment in their economy and society, the entry and establishment (and conditions for these) of foreign investments, and to require that foreign investors fulfil obligations towards the national development, social and environmental goals of host countries.

#### *(c) Strengthening existing international arrangements and promoting new ones for channelling foreign investments towards development, social and environmental goals*

International arrangements for facilitating or ensuring the implementation of the positive social, developmental and environmental roles of foreign investments and investors should be strengthened. For example:

- (i) The implementation of the Set of Principles and Rules on Restrictive Business Practices (based in UNCTAD) should be strengthened, and the negotiations on the Draft International Code of Conduct on the Transfer of Technology could be revived;

- (ii) The WHO-based Code of Marketing of Breast-milk Substitutes could serve as a model for similar guidelines relating to the marketing of other products;
- (iii) The UN General Assembly's Guidelines for Consumer Protection should be strengthened and subject to better monitoring and implementation;
- (iv) In the context of the implementation of Agenda 21, the Commission on Sustainable Development could establish a process of obliging enterprises, especially those engaged in cross-border investments, to respect international standards on environmental issues;
- (v) A new international effort can be initiated to facilitate a process or an arrangement whereby foreign investors are required to respect and contribute to the development, social and environmental objectives, policies and practices of host countries; this could incorporate some elements from the draft Code of Conduct on TNCs;
- (vi) The process of establishing new protocols and conventions to protect the environment should be accelerated while the existing agreements should be strengthened, in view of the increasing global crisis of the environment. These agreements should specifically include provisions on criteria for good practices of and policies on foreign investments and the role and responsibilities of foreign investors.

## **V. GENERAL CONCLUSIONS AND PROPOSALS**

### **A. Balancing opportunities and problems resulting from globalization**

Among the biggest dilemmas for developing countries is whether they should open themselves up to the globalization process (in the hope of obtaining some of the benefits), or to take a more cautious approach to avoid risks (which would attract criticisms from the mainstream institutions that are sure to lecture the countries concerned that they would be left behind).

The challenge is whether developing countries can take advantage of the liberalization process, which to a large extent is being pushed on them externally, while at the same time avoiding or minimizing the disruptive consequences on their societies and economies. The ability to manage liberalization and globalization will be a crucial aspect of national policy-making in the years ahead. At this point the danger is that most developing countries, under great pressure from agencies such as the WTO, the IMF and the World Bank, will go along with the trend and institute more as well as rapid liberalization policies, without a clear idea of the conditions needed to successfully take the associated risks.

Instead of rapid liberalization, a selective approach to liberalization is more appropriate. The aim of this would be to strike a careful balance between opening the domestic market (to benefit consumers) and protecting it to take into account especially the interests of small producers.

A useful summary of the opportunities and challenges of globalization has been given in the UNCTAD Secretary General's report to the ninth session of the Conference (UNCTAD, 1996a).

The main opportunities it lists are: trading opportunities arising from the Uruguay Round; opportunities from international capital flows and financing of development (UNCTAD warned of risks involved as well, and noted that the majority of developing countries did not enjoy these facilities); opportunities provided by international production through FDI and increased opportunities for economic cooperation among developing countries (ECDC) to boost South-South cooperation.

The UNCTAD report also warns of the risks, stating that “the processes of globalization and liberalization can also give rise to a number of potential negative consequences and challenges to development”. It gives details of the following three problems: Loss of policy autonomy (policy instruments available to developing countries have narrowed as a result of economic liberalization policies and stringent multilateral disciplines); financial openness and the risk of instability and disruption to development sentiments of external investors; and the phenomenon of marginalization (in which some developing countries, especially LDCs, are unable to benefit from or meaningfully participate in globalization due to structural supply-side weaknesses and debt).

Although the UNCTAD report provides a useful summary of some important implications of globalization, they are by no means exhaustive. The summary does, however, point to the immense difficulties that face many (and perhaps most) developing countries in trying to survive or thrive in a globalized economy. The least developed countries have too many problems such as debt and low commodity prices, and too weak an infrastructure and capacity to develop industrial exports. At the same time they face the threats of local firms and farms being overrun by foreign products and companies as their countries liberalize. Even the stronger developing countries find great difficulties in being able to manage and balance the costs and benefits of globalization, as the recent financial crisis in East Asian countries show.

## **B. The need for South-South policy coordination among developing countries**

In order to widen their policy options in the future and to strengthen their bargaining power, developing countries have to organize themselves to strive for a more democratic global system.

Countries of the South, at many different forums, have collectively reaffirmed their view that the social and economic role of the UN and its agencies is even more necessary in view of globalization. While they may have spoken up, they have to do even more to assert their belief in the UN's role and to intensify the fight to reverse its decline. They should also strengthen South-South cooperation, with the support of UN agencies such as the UNCTAD and UNDP as well as through their own mechanisms and organizations. This cooperation should include an increase in trade, investment and communications links at the bilateral level and between regions, as well as joint projects involving several South countries.

Equally or even more urgently required is South-South cooperation in the area of policy coordination in reaching common positions. This is especially because policies that used to be taken at the national level as the prerogative of national governments are increasingly being made at forums, institutions and negotiations at both the international and regional level. Without a more effective collective voice at such international forums, Southern countries will find even more that their national policies on economic, social and cultural matters being made and dominated over by the more powerful Northern governments and the institutions they control.

At present, there are few institutions of the South and their capacity is weak. Like-minded countries of the South should consider initiatives to start or strengthen centres of research and coordination, including those that are independent or private, that can help them in their preparations for negotiations as well as strategic thinking and long-term planning. Greater collaboration among regional institutions of the South (for example, ASEAN, SAARC, SADC, Mercusor, Caricom, etc.), especially in sharing of information and coordination of policies and positions, would be beneficial.

Among the objectives of South-South policy coordination could be efforts to strengthen the UN system and to democratize international institutions and relations, which are covered below.

### **C. The need for appropriate and democratic global governance**

In order for developing countries to avoid bleak prospects in the 21st century, they must be given the space and opportunity to strengthen their economies and to develop their social infrastructure, while having environmentally sound practices. For this to happen, there has to be a much more favourable international environment, starting with the democratization of international relations and institutions, so that the South can have an active role in decision-making.

The developing countries should have more rights of participation in decision-making processes in the IMF, World Bank and WTO, which should also be made more accountable to the public and to the local and poor communities. These institutions have been under the control of the governments of developed countries due to the systems of decision-making and governance. There has long been a perception that as a result of such dominance, the three institutions have tended to have policies or rules that are biased towards the interests of the developed countries, while developing countries have either benefited less or have also suffered from the wrong policies and biased rules. There is thus a need to reform the decision-making processes so as to give developing countries their right to adequate participation; and to review and where needed to change the content of policies and rules so that they reflect the interests of developing countries that form the majority of the membership.

As it is the most universal and democratic international forum, the United Nations and its agencies should be given the opportunity and resources to maintain their identity, have their approach and development focus reaffirmed, and strengthen their programmes and activities. The strong trend of removing the resources and authority of the UN in global economic and social issues, in favour of the Bretton Woods institutions and the WTO, should be reversed.

In particular, those Northern countries that have downgraded their commitment to the UN should reverse this attitude and, instead, affirm its indispensable and valuable role in advocating the social and developmental dimension in the process of rapid global change. The world, and especially the developing countries, require that this dimension be kept alive and indeed strengthened greatly, otherwise there is a danger that a monolithic laissez-faire approach to globalization and to development will cause immense harm.

Only a great strengthening of the UN will allow it to play its compensatory role more significantly and effectively. But of course a complementary “safety net” function is the minimum that should be set for the UN. For the South as well as the international community to make

progress towards redressing the basic inequities in the international system, the UN must be able to make the leap: from merely offsetting the social fallout of unequal structures and liberalization, to fighting against the basic causes of poverty, inequities, social tensions and unsustainable development. The more this is done, the more options and chances are there for developing countries in future.

It is vital that the UN continues to promote developing countries' rights and interests, an equitable world order and the realization of human and development rights as its central economic and social goals. There is a danger that some UN agencies (and the Secretariat itself) may be influenced by conservative political forces to join in the laissez-faire approach or merely be content to play a second-fiddle role of taking care of the adverse social effects of laissez-faire policies promoted by other agencies. The UN should therefore keep true to its mission of promoting appropriate development and justice for the world's people, and to always advocate for policies and programmes that promote this mission, otherwise it too would lose its credibility.

#### **D. Rebalancing the roles of State and market**

In considering their options in the globalized economy, developing countries have to seriously review the liberalization experience and make important conclusions on the balance and mix between the roles of the State and the market. As the Indian economists Amit Bhaduri and Deepak Nayyar (1996) have argued, contrary to the laissez-faire structural adjustment model, both the market and the State have key roles. According to them, an unbridled economic role for the government in the name of distributive justice is often a recipe for disaster in the long run, but, on the other hand, market solutions are often ruthless to the poor. Moreover, government failure does not imply that a reliance only on markets will succeed.

The study warns against fundamentalism in belief in either State or market. While there are failures in State policies, there can also be serious market failures. What is important is to recognize both government and market failures and introduce correcting devices against both. The proper functioning of a market needs the support and guidance of the State, while conversely the State cannot do without the markets. Looking at the experience of the late industrializers, the authors conclude that the belief that markets know best, or that State intervention is counterproductive in the process of industrialization, is not borne out by their history.

Experience from the second half of the twentieth century suggests that the guiding and supportive role of the State has been the very foundation of successful development in countries which are latecomers to industrialization. State intervention created initial conditions for industrialization through State investment in infrastructure, development of human resources, and agrarian reform. In the early stages of industrialization, a key role of the State was protection of infant industries through tariffs and other means. In the later stages of industrialization, the nature of State intervention in the market must change and become functional, institutional or strategic.



## **E. The search for appropriate development strategies**

The review of structural adjustment policies, and of the liberal “free-market” model in general, shows that a reconceptualization of development strategies is required, and that alternative approaches are needed.

An important issue is whether developing countries will be allowed to learn lessons from and adopt key aspects of these alternative approaches. For this to happen, the policy conditions imposed through structural adjustment have to be loosened, and some of the multilateral disciplines on developing countries through the WTO Agreements have to be reexamined.

In the search for alternative options for developing countries, work also has to be increased on developing economic and development approaches that are based on the principles of sustainable development. The integration of environment with economics, and in a socially equitable manner, is perhaps the most important challenge for developing countries and for the world as a whole in the next few decades.

However, international discussions on the environment can only reach a satisfactory conclusion if they are conducted within an agreed equitable framework. The North, with its indisputable power, should not make the environmental issue a new instrument of domination over the South. It should be accepted by all that the North should carry the bulk of the burden and responsibility for adjustment towards more ecological forms of production. This is because most of the present global environmental problems are due mainly to the North, which also possesses the financial resources and the economic capacity to reduce their output and consumption levels.

In the 21st century, much more focus has to be placed on changing economic policies and behaviour in order that the patterns of consumption and production can be changed to become environmentally sound. What needs to be discussed is not only the development model of the South but even much more the economic model of the North, and of course the international economic order.

There is also a need to strive for governance at a national level that combines economic development, environmental concerns and social justice. In both North and South, the wide disparities in wealth and income within countries have to be narrowed. In a situation of improved equity, it would be more possible to plan and implement strategies of economic adjustment to ecological and social goals.

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