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PROMOTING COMPETITIVENESS AND MANAGING FINANCIAL INTEGRATION IN THE GLOBAL ECONOMY

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I. COMPETITIVENESS AND INTEGRATION IN THE GLOBAL ECONOMY: NEW APPROACHES

1. In today's world, becoming more fully and dynamically integrated into global markets on the basis of increased competitiveness has become a precondition for achieving sustained growth and meeting the challenges of social equity. Growth at the end of this century requires perseverance in the strategy of forming linkages with international markets and improving the quality of those linkages, with related efforts to disseminate technology and invest in human resources.

2. In view of these challenges, and on the basis of its proposal on changing production patterns with social equity, ECLAC has produced a number of documents intended to contribute to the reflections and actions of the countries of the region by offering a new approach for meeting the challenges of the late twentieth century. The concept of competitiveness plays a central role in that proposal, which basically suggests that countries change their production patterns in order to enhance their international competitiveness, through the deliberate and systematic incorporation of technical progress into the production process and a decided effort to invest in human resources. This implies that increasing productivity should be a prime concern.

3. The proposal takes a systemic approach to competitiveness, which is rooted in individual firms but is strongly influenced by the quality of the setting in which their activities take place (the education system, physical infrastructure, the technological base, the energy and transport systems, the public sector, the financial and legal systems, etc.). The competitiveness of firms is affected by the quality of institutions and human resources and by the various components of "country cost".

4. Although this proposal attaches decisive importance to the maintenance of macroeconomic balances, traditionally so elusive in Latin America, that effort is not limited to sound macroeconomic management or to "correct" price patterns. It primarily concerns these two components, but also includes sectoral policies, complementary redistributive measures, institutional reforms to facilitate strategic consensus-building among different economic and social actors, interlinkage of the production base, strengthening of enterprises and the emergence, in the market, of a kind of competitiveness that is "genuine" (based on technical progress and increased productivity) rather than "spurious" (attributable to low wages or to rents derived from the plundering of natural resources).

5. To resume the debate put forward in the article by Krugman (1994) in *Foreign Affairs*, what distinguishes the ECLAC approach is the fact that its view of competitiveness is based on increased productivity, requires a sound macroeconomic foundation and calls for an open economy. It therefore is not a substitute for appropriate economic policies or a pretext for protectionism, and emphasizes policies and institutions that foster the spread of technology and investment in human resources.

1. The Concept of Competitiveness

6. The aim of competitiveness is to achieve both a better position in international markets and a better standard of living for the population, within open economies with few restrictions on trade and free markets (United States Council of Economic Advisers, 1985; ECLAC, 1990; OECD, 1992).

7. Changes in production patterns must be based on the deliberate and systematic incorporation of technical progress into productive activities and increased investment in human resources, in order to achieve steady increases in productivity. In the current context of globalization and rapid technological change, constantly rising productivity is the key to competitiveness and to higher standards of living in the medium term (Krugman and Summers, 1988).

8. The traditional approach to competitiveness focuses on the evolution of labour costs, the real exchange rate and productivity, which affects unit labour costs. The pillars of export-oriented economic policy are basically trade liberalization (with low, uniform tariffs), the abolition of non-tariff barriers, real devaluation and the reduction of labour costs, by either cutting wages or increasing labour productivity through technical modernization.

9. A model of this type has a powerful logic in a context of competitive international markets with high price-elasticity of world demand for tradable goods consisting of relatively homogeneous products, and where the qualitative factors influencing the trading capacity of a country remain more or less constant. However, it loses relevance when a substantial and growing proportion of international trade takes place under conditions of imperfect competition and intra-industry specialization based on product differentiation.

10. It is therefore possible to speak of price competitiveness versus structural competitiveness (Durand and Giorno, 1987). The latter, without ignoring the price, cost and exchange-rate factors, emphasizes the issues of management, technological innovation and dissemination, quality of human resources and production specialization policies that reflect trends in international markets. Competitiveness is not limited to trade liberalization and "correct" prices; it also concerns Xin addition to those elementsX the influence of economies of scale, the advantages of experience, innovation and technological learning processes under models of trade specialization (Krugman, 1991).

11. The traditional approach does not include a theory of technical change, and considers the latter an exogenous factor. Successive developments have led to more sophisticated ways of measuring the "residual" element of the production function, incorporating research and development, economies of scale and improvements in labour quality (Denison, 1985; Baily, 1986). Despite these advances in measuring the contribution of tangible factors to growth, the "residual" remains significant and the contributions of intangible variables, such as the regulatory framework, interference in the price system and the efficiency of firms, have also been incorporated (Denison, 1985; United States Council of Economic Advisers, 1989; Leibenstein, 1987; Olson, 1988).

2. Eight proposals on competitiveness

1. Competitiveness should revolve around the absorption of technology and investment in human resources, with emphasis on productivity, quality and internationalization.

2. Critical contextual variables include macroeconomic stability, policies to liberalize trade and build international linkages, and the presence of competitive markets.

3. The objectives of policies to promote competitiveness are:

    i) to improve the quality of factors of production;
    ii) to ensure proper macroeconomic management and sound economic policies;
    iii) to create a context of competitive, transparent and easily accessible markets; and
    iv) to implement productive development policies to strengthen enterprises, promote the spread of technology and open up trade opportunities.

4. These are really productive development policies, rather than industrial policies proper. Increasing productivity and international competitiveness requires not only appropriate macroeconomic and trade policies, but also micro- and meso-economic policies; in other words, modernization of both the firms themselves (technology, equipment, organization, labour relations) and the environment in which they operate (factor markets and intra-firm coordination).

    The systemic nature of competitiveness requires efforts to integrate the production system and to bring about a progressive convergence of productivity levels. This suggests that sectoral compartmentalization should be rejected in favour of strengthening the links between exports of commodities, manufactures and services; that chains of production should be developed on the basis of existing comparative advantages; and that efforts should be made to promote production linkages to build dynamic comparative advantages based on natural resources.

5. Grounds for intervention: Government intervention is justified by market imperfections. The most recent approaches, while still stressing the shortcomings of the capital, labour and product markets, nevertheless do not try to take their place in the allocation of investment resources. They seek to correct the flaws observed directly, in order to strengthen the allocative role of the market in production decisions. In addition to the generally known flaws of the capital market (adverse selection, moral risk, segmentation), there are also such flaws as lack of coordination, insufficient provision of public goods such as information, knowledge, dissemination of technology and training, and weakness of the associated learning processes (Stiglitz, 1989).

6. Consequently, current productive development policies (ECLAC, 1994; Rosales, 1994) are designed to:

   i) develop as yet incomplete markets (for technology, human capital, long-term capital, foreign exchange) by correcting such shortcomings as underinvestment in export activities (new products, new markets) and insufficient support for pioneer firms;

   ii) achieve rising yields and strategic forms of complementarity which foster systemic competitiveness;

   iii) regulate markets of crucial importance for competitiveness, such as the financial system, public telecommunications services, energy and other areas of the infrastructure;

   iv) open up opportunities for private investment in infrastructure (roads, ports, airports and sanitation services), with effective rate-setting mechanisms and economic management criteria that shift the cost of using infrastructure to the users themselves;

   v) support the internationalization of production by stimulating investment abroad, alliances with foreign partners, greater national participation in marketing chains and a firmer private-sector commitment to strategies for promoting trade and enhancing product quality and brand-name recognition.

7. Complementarity between the market and public policies:Public policies should not interfere with the market; they should attempt to improve its operation. Adjustment should be based on the principles of the market and competition, and should therefore be the responsibility of firms themselves. The public sector's job is to ensure suitable conditions for investment, the pre-eminence of competition, the mobility of resources and ready access to markets. Intervention is understood to be based on horizontal instruments which improve coordination within the private sector and between it and the public sector and reduce the risks involved in new investments by improving the supply of information and fostering access to development instruments.

8. Characteristics of incentives: The proposed incentives have the following features:

i) they stress dynamic efficiency and competitiveness;
ii) they are limited in time, decreasing, provide for their own eventual elimination and are linked to precise export goals;
iii) they have modest goals and concentrate the critical mass of public-sector measures on programmes which will have a decisive impact and are in keeping with that sector's technical and administrative capacity;
iv) their administration and follow-up are decentralized and gradually transferred to the private sector;
v) they selectively focus on pioneering and/or knowledge-intensive exports;
vi) they promote association between the public and private sectors, within the private sector and within individual firms;
vii) they derive from public Xrather than StateX policies, since they are based on agreement among different actors and are consensual rather than technocratic or administrative in nature.

3. Systemic competitiveness: A summary

12. The notion of competitiveness outlined above passes the test of Krugman's (1994) ideas on the subject and is in line with recent advances in the theory of economic growth. The following are the main features of this systemic view, that it:

i) revolves around increased productivity and investment in human resources;

ii) is neither a replacement for a sound economic policy nor a pretext for protectionism; instead, it requires a context of proper macroeconomic management and trade liberalization;

iii) does not try to pick winners, it seeks to avoid missing opportunities owing to a lack of coordination between different actors or of flexibility in instruments and institutions;

iv) combines horizontal policies with selective support for pioneering or innovative exporters whose potential competitiveness is hindered by market constraints;

v) views technical change as a gradual learning process and stresses the importance of learning for growth, as noted by Lucas (1988) and Stiglitz (1987);

vi) endogenizes the learning process and the accumulation of human capital in the production function, yielding growing returns in the production of finished goods (Lucas, 1988) owing to the positive externalities associated with investment in human resources.

vii) recognizes that human capital- and learning-intensiveness vary by sector and that productive development policies should broaden the effects of learning and increase investment in human resources, focusing on products that offer greater capacity for learning and, ultimately, for growth and well-being;

viii) attaches importance to the structure of markets (Krugman, 1992) as a key variable of an economy's functioning, rejecting the assumption of perfect competition (Romer, 1986). This implies the need to ensure that markets are competitive by combining deregulation and regulation according to each market's characteristics;

ix) conceives of innovation as a public good (Arrow, 1962) that should be stimulated with policies and institutions. Studies on technological change and labour relations agree that the main obstacle to innovation is the existence of non-cooperative relations within firms. They also highlight the need for a well-qualified, flexible and motivated workforce, as a critical input for technological innovation; that is, the need for firms to create a climate of cooperation and openness to participation and innovation. This will increasingly become a crucial feature of competitive performance;

x) stresses the importance of institutions for economic development (Williamson, 1994; Doeringer and Streeten, 1990). An efficient State, competitive markets, secure property rights and stable rules of the game form the basic institutional framework for strengthening competitiveness. These institutional arrangements can also lead to institutional innovations for cooperating and competing, such as the promotion of business associations for productive development, alliances between large and small firms, subcontracting, indirect exporters and linkages within enterprises and between the private and public sectors;

xi) reflects the ideas on organizational change and the new industrial paradigm that appear in studies on the behaviour of firms (Porter, 1980; Lawrence and Dyer, 1983); economies of scale or of scope (Chandler, 1977; Elbaum and Lazonick, 1986); business strategies (Bluestone and Harrison, 1982; Piore and Sabel, 1984); the product cycle (Norton, 1986); and the working environment (Kieschnick, 1981; Wheaton, 1979).

4. Specific Features of Competitiveness ECLAC=s Approach

13. In the ECLAC=s view, competitiveness has a macroeconomic basis, a market friendly approach , a systemic nature, and emphasis on productivity, technical change and sustainability.

A Macroeconomic basis

14. Maintaining macroeconomic balances Xlow and declining inflation, fiscal saving, incentives for saving and investment, promotion of increased productivity and defence of the real exchange rateX is a basic requirement for competitiveness. Exchange-rate instability, for example, raises transaction costs, increases uncertainty and may block investment. From a broader standpoint, it is necessary to seek fuller incorporation in the international economy while maintaining macroeconomic stability. This means taking further steps in the direction of trade diversification and financial openness, albeit subject to the necessary safeguards in terms of gradualism, portfolio diversification, risk coverage and stabilization funds, in order to obviate the transmission of external disturbances to the domestic economy.

B. The market-friendly approach

15. Competitiveness requires transparent competitive markets that are readily accessible. However, "free markets" do not necessarily provide these conditions; where they are lacking, the State should not substitute for the market, but instead should support efforts to create or increase competitiveness. Maintaining stable incentives and reducing search, transaction and information costs are other ways of supporting competitiveness.

16. The promotion of competition is central to this proposal, and encompasses a number of areas: i) deregulating competitive markets, which represent the majority; ii) regulating markets dominated by natural monopolies or other flaws of industrial organization, which are few but decisive for the well-being of individuals; and iii) deepening and extending the coverage of incipient or underdeveloped markets, such as those for technology, training and long-term capital (ECLAC, 1994).

C. Systemic nature

17. In today's world, the competition is not between firms but between systems. The firm is the hub of competitiveness and innovation, but it is an integral part of a system of linkages which includes its suppliers of goods and services; the financial, educational, technological, energy, transport and telecommunications systems; infrastructure; and the quality of the public sector and of relations within the firm itself.

18. Shortcomings in any of these areas affect the firm's competitiveness. Building systems of competitiveness therefore demands cooperation between the public and private sectors and within the private sector itself, as well as the capacity to form long-term strategic alliances, with special emphasis on export promotion, technology, education and training, along with flexible complementation agreements and shared internationalization strategies.

19. Systemic competitiveness refers to the fact that changes in production patterns must include the whole system in which firms operate. It also calls for the modernization of all production systems, with emphasis on intersectoral linkage and system-wide increases in productivity. This will enable industrialization to move beyond the narrow sectoral framework in which it has traditionally been confined and to become linked with commodity exports and the services sector, so that the production system becomes integrated and productivity levels progressively converge.

20. A corollary of the theory of systemic competitiveness concerns the quality of institutions, as emphasized in the new institutional economics (Williamson, 1994). In particular, this concept transcends the rigid "State versus market" dichotomy. A systemic approach requires competitive, transparent, easily accessible markets, on the one hand, and an efficient, catalytic and democratic State, on the other.

21. This systemic approach to competitiveness goes beyond narrow concepts that limit its analysis to the exchange rate and the trade balance. As the "lost decade" vividly showed in Latin America, it is all too easy to achieve big trade surpluses through severe real devaluations, with all that they imply in terms of compression of imports, reductions in real wages and even cuts in social expenditure.

D. Emphasis on productivity and technical change

22. Competitiveness now depends not so much on advantages in terms of wages or natural resources as on the quality of human resources and the capacity to absorb technology. The promotion of competitiveness thus involves the application of policies to develop human resources (through education and training) and to strengthen the technological base. In addition, macroeconomic stability and smoothly functioning markets are decisive contextual determinants of competitiveness.

23. Genuine competitiveness is based on increased productivity, and therefore on the absorption of technical progress by the production system. Technical progress is not limited to the development and adaptation of "hard" technologies; it also includes firms' managerial capacity, the quality of the labour force, the working environment within firms and the organization of their operations.

24. The proposal on changing production patterns does not imply that some sectors should be preferred over others; it does, however, maintain that the pattern of trade specialization should be gradually directed towards exports that perform dynamically in international markets. This does not mean that there should be a radical polarization between manufactures and commodities, since the important thing is the knowledge- and technology-intensiveness of each product, along with the promotion of chains of production for exports. In agriculture, for example, fresh products require technologically complex processes of production, selection, quality control, storage and transport.

25. The region cannot afford to neglect its rich endowment of natural resources, which form an important part of its production function, especially since technological advances are expanding the possibilities for using natural resources and the region has developed state-of-the-art expertise in agriculture, fisheries, forestry and mining. The challenge is to tap the potential of natural resources to contribute to industrialization, with emphasis on promoting service and production linkages for export activities and stimulating production services, the development of suppliers and the production of intermediate inputs and associated capital goods.

E. The link with an open regionalism

26. According to the ECLAC proposal on changing production patterns with social equity, integration is seen as a way of achieving a development model in which economic growth and social equity are enhanced simultaneously. ECLAC uses the term A*open regionalism*≅ to refer a new process that results from reconciling two phenomena: the interdependence that stems from special, preferential agreements, and that which basically arises from the market signals that are produced by trade liberalization in general.

27. The contribution of A*open regionalism*≅ to enhancing production patterns with social equity may be seen in an increase in investments, exports and in an absorption of technological progress based on regional or subregional processes of coordination of production and interaction between public and private agents. In other words, is necessary to identify and evaluate the impact of integration on efficiency (static effects), the investment dynamic (dynamic effects), absorption of technological progress and regional products linkages.

F. Sustainability

28. Sustainability refers to the need for medium-term competitiveness to take its environmental impacts into account. Ignoring this issue would dangerously limit possibilities for achieving growth and competitiveness. It is necessary to progress towards a sustainable form of development that assigns higher priority to environmental impact assessment of large-scale investment projects, the gradual spread of the "polluter pays principle" and the sustainable use of natural resources, with more intensive application of environmental and information technologies.

29. It is vital to raise the environmental awareness of all social actors and institutions, to make more frequent use of prices for environmental ends and to incorporate the technological dimension into environmental issues, for purposes of both preserving the environment and taking advantage of opportunities to market and export environmental technologies. The quality of the environment is increasingly becoming a variable of competitiveness, which will take on more importance as countries conclude trade agreements that facilitate their entry into more sophisticated markets.

5. Indicators of competitiveness in an integrated approach

30. An analysis of an economy's competitive position cannot stop at indicators on the trade balance. It must go on to consider variables of macroeconomic stability, changes in the production system and competitive performance as such. A preliminary proposal in that regard could include the following elements:

a) **Macro-financial performance** concerns: Inflation and output growth rates; fiscal deficit and its financing; exchange rate and current-account deficit; and external and internal indebtedness.

31. The proposal on changing production patterns with social equity calls for low and declining inflation, growth in per capita GDP, stable fiscal accounts, a high and stable real exchange rate and a moderate and sustainable current-account deficit. The aim is to achieve consistently stable year-end fiscal balances while limiting access to credit as a financing mechanism, and to achieve external account balances based on stable values of these variables, with emphasis on long-term capital.

b) **Macroeconomics of structural change** concerns:Rates of saving, investment and exports as percentages of GDP; performance of non-traditional exports; productivity; real wages; and capital yields.

32. A central feature of changing production patterns with social equity is its orientation towards higher levels of saving, investment and exports as percentages of GDP, steady increases in productivity and a dynamic export sector sustained by non-traditional exports.

c) **Competitive performance** concerns: "Competitive position" and "efficiency"; export diversification (products, markets and exporters); education: public spending on education as a percentage of GDP; spending on training as a percentage of GDP and the wage bill; and infrastructure: deterioration and degree of use; spending on research and development as a percentage of GDP; performance indicators: education, training and technology.

33. The degree of export diversification and the indicators elaborated by ECLAC (1992) on competitive position and efficiency in international trade can be used to measure the progress made in enhancing competitiveness.

34. Input variables include spending on education, training and research and development, as well as needs in terms of infrastructure and investment plans under way. In any case, input variables i.e., resources oriented towards competitiveness must be complemented by indicators of performance and results. In this regard, it would be useful to construct indicators of technology dissemination, skilled workers who find jobs in the areas for which they were trained and on education quality.

35. Growing economic globalization has led to a situation where sectors with incipient or fully developed competitiveness coexist with sectors whose competitiveness is threatened or is lagging behind. Investment will therefore be affected by retooling processes. This is creating a new context for employment policies, as work patterns shift from a fixed, predictable and guaranteed career path within a single firm to more flexible arrangements both within and outside firms. In keeping with that trend, the focus of labour regulations should be shifted from the protection of jobs to the protection of wages in the transition from one job to another. From this standpoint, the right to work will become increasingly synonymous with the right to training, in so far as the latter can provide workers with the skills demanded by new jobs.

36. The gradual change in the qualifications required emphasizes versatility and flexible specialization, thereby posing new challenges for education and training policies. In that regard, flexible competitiveness can be promoted by establishing a national employment and human resources training network that interlinks the functions of the training system, retooling policies, unemployment insurance and improvements in the supply of information on the labour market, with municipal offices that specialize in providing information on employment and training

II. MANAGING FINANCIAL INTEGRATION

1. National responses to the challenges of globalization: Sound macroeconomic policies and financial and banking reform

37. Due to a combination of external and internal factors, the regional situation of the 1980s, which was characterized by a negative transfer of financial resources, was reversed in the early years of this decade, and private external financing reappeared, with vigorous sources of financing that were more diversified than formerly. In particular, foreign direct investment increased, as did portfolio investment in bonds and shares B either directly or in the form of ADRs B and participation by foreign investors in emerging markets.

38. The reintegration of the region into international financial markets provides an opportunity to supplement internal savings so that the requirements of production transformation with equity can be met. Of particular importance is the contribution that external saving can make in the implementation of investments to increase the competitiveness of the region's economies and the well-being of its population.

39. Generally speaking, however, this reversal in the trend of net external financing, whereby the situation has changed from one of great stringency to one of remarkable abundance, has not been reflected proportionately in investment levels. Furthermore, in a number of countries the sheer scale of these flows has produced some unwanted effects, especially on the exchange rate and money supply, and vulnerability to external shocks has increased. In some cases, situations have arisen in which these effects, by diverting national savings into the consumption of imported goods, have been detrimental to the objective of protecting the tradable sector of the economy.

2. Some Major Challenges for Economic Policy

A. Gradual and Phased Opening of the Capital Account

40. In the history of Latin America there have been periods when large amounts of capital have entered the region, followed on several occasions by periods of debt crisis. This has given rise to a major debate on the dynamics of the capital account liberalization process. At present, there is a measure of agreement on the need for this liberalization process to be carried out in phases, and on the advisability of doing this only after other liberalization processes have been consolidated, most particularly the liberalization of trade and of the internal financial market.

As regards the speed with which the capital account is opened up, if macroeconomic and real exchange rate stability are to be maintained this process must not outstrip the ability of economies to absorb and efficiently allocate external resources. It might be advisable, in the first instance, to liberalize only long-term capital inflows, before providing facilities for short-term financial capital transactions. As regards capital outflows, priority should be given to trade credits, in the interests of export promotion, and to direct investments by domestic companies abroad, which is also a way for these to improve their export platform.

For the commercial account to be liberalized efficiently, real devaluation is required both to make this successful and to reduce the costs of the production and employment transition. Liberalization of the capital account stimulates the flow of external capital due to interest rate differentials, leading to appreciation of the currency. Experience has shown that the financial markets adjust much more quickly than the real markets, which means that the most likely scenario when capital accounts are opened prematurely is a sharp currency appreciation, producing contradictory signals between trade liberalization and capital account liberalization.

In respect of this, the consensus is that: i) trade liberalization must come before external financial liberalization; ii) during the transitional period of trade reform, which may last for around a decade, tight control needs to be maintained over these financial flows to prevent the currency appreciating; and iii) it is better to relax restrictions on the capital account only once the new production structure has been consolidated.

To ensure macroeconomic stability it is advisable to channel financial movements as far as possible into the real economy, in order to transmit only changes that are permanent. Given that financial movements are having a greater and greater effect in determining exchange rates and interest rates, sometimes without regard to appropriate values in fundamental macroeconomic variables, exchange and interest rate policy cannot be left to the mercy of volatile flows of capital. It is not easy to distinguish between transitory and permanent movements, but the worst thing to do is to assume that all short-term movements are permanent.

Inadequate financial regulation and indiscriminate liberalization of the capital account end up by transmitting all the volatility of the financial markets to production activities. The real exchange rate ceases to perform its function of allocating resources for use in modernizing the

production system, and the dynamism of investment in tradables is affected.

! POLICIES FOR STABILITY AND SUSTAINED GROWTH

If a policy of production transformation with equity is to be pursued, there must be a strong commitment to policies that promote domestic saving and channel these savings into the development of production capacity. The greater the domestic component of investment financing, the more sustainable growth will be.

Since capital flows can affect national macroeconomic variables, as well as being affected by them, governments need to exercise caution on two fronts. Firstly, they must avoid situations in which capital flows create anomalous values or large distortions in fundamental macroeconomic indicators such as real exchange rates and interest rates, sectoral and national borrowing, inflation (including asset prices), consumption, investment and the production of tradables.

Secondly, governments must avoid using capital inflows as their main tool for achieving a rigid or extreme target for a single internal economic variable, especially over a long period; one common situation is where governments try to use an appreciating exchange rate to restrain inflation. When they do this, they generally throw other important variables out of balance, and thereby affect the very instrument they were trying to use, i.e. capital flows.

Capital flows are not always consistent with the objectives of macroeconomic stability in the broad sense of the term, with sustained economic growth, or with social equity; a certain amount of direct or indirect government "management" is therefore justified as a way of influencing the volume and composition of these flows.

In periods where resources are relatively scarce, as is the case in the 1998-1999 period, there are good grounds for seeking both specific and more general ways of attracting capital flows and putting up barriers to make it more difficult for capital to leave. The recent decline in capital flows to a large part of Latin America clearly illustrates the way external flows can dry up and shows how important it is, in circumstances like these, for governments to make special efforts to attract capital. The opposite would hold in cases where there was clearly an abundance of capital, as there was in many countries of Latin America in the period 1990-94: in that situation, it would have been desirable for certain types of capital inflow to be restricted and for channels to be opened so that capital could depart.

There are different ways of managing capital flows. The more urgently such management is needed, and the more underdeveloped fiscal and monetary policies are, the greater justification there is likely to be for the use of direct regulations applying to certain types of external capital, albeit only temporarily. Of course, it is often held that controls of any kind are inefficient and likely to be evaded by the ever more complex operations of the capital markets. As Williamson points out, however (1992, p. 189), "claims about the inefficiency of capital controls are greatly exaggerated". As was mentioned earlier, the use of these instruments obviously involves costs, but these need to be compared with the general social benefits obtained from the point of view of macroeconomic stability, investment and growth, and with the feasibility and reliability of

other possible ways of achieving the same objective. As Zahler maintains (1992), any microeconomic costs that might be incurred by regulating capital movements may be more than compensated for by the benefits deriving from greater macroeconomic stability.

Administering capital flows entails some costs. Recent experience has shown in a dramatic way, however, that always leaving the market to determine the volume and composition of these flows can also entail costs, and these can be substantially higher.

! IMPROVING DOMESTIC FINANCIAL MARKETS

When reorganization of financial systems is carried out, including liberalization of capital movements, a priority objective must be to provide incentives for resources to be channelled into savings and investment in a way that strongly supports the development of production capacity. This role has not been emphasized enough in the monetary and financial reforms being implemented in the region. There needs to be more concern about the relationship between the financial system and national savings and investment processes, and between this system and external financial markets.

The extent to which external capital flows can help further a strategy of production transformation with equity depends in great measure on the characteristics of domestic financial markets. This assertion is based on the lessons of the external debt crisis, which was caused by large inflows of external bank credits. On that occasion the capital markets were unable to prevent "financial bubbles", adverse selection and moral hazard, which are inbuilt characteristics of financial markets.

The challenges involved in financial and prudential regulation of domestic financial markets become clear when we consider the great speed with which external funds can enter these markets. Unless there has been active development of financial instruments and institutions, including the very public institutions that are responsible for regulation and supervision, the interaction between these funds and rapidly growing financial systems could lead to macroeconomic instability and distortions as they are channelled into high-risk credits (or "credit bubbles"), steep rises in the prices of existing stock market securities (or "stock market bubbles") and rises in the prices of real estate and other assets.

There is a clear policy deficit in the relationship between the financial markets and the formation of development capital, and there is a need for institutional mechanisms to supplement or improve the markets on the basis of three criteria. Firstly, the inclusion of a dynamic long-term financial market segment to enable production projects to be financed. This will involve discouraging speculative segments and concentrating on long-term international capital accompanied by access to technology and export markets. Secondly, the promotion of access to financing for small and medium-sized companies that suffer from the segmentation of the capital market. Thirdly, recognition of the fact that, in countries with "emerging" stock markets, financial liberalization of the capital account which opens this up to international portfolio investment entails a risk of excessive external borrowing and excessive stock market and exchange rate fluctuations.

Concern about the risks associated with the financial markets, such as the creation of

speculative "bubbles", means there is a need to adopt regulatory and supervisory mechanisms to ensure the stability of the financial institutions operating in the capital markets. These mechanisms are particularly vital in open free-market economies. Strengthened supervision and regulation can reduce the risks referred to and help make the process of attracting portfolio investment from abroad a more orderly and stable one. Of course, for regulation to be effective the countries will need to improve the systems they use to monitor flows of external capital. In the case of financial institutions, this needs to be done not just at the microeconomic level but also at the macroeconomic one to ensure that the size and composition of capital flows are compatible with economic stability.

REFORMING THE INTERNATIONAL FINANCIAL SYSTEM

The reform must encompass a number of interrelated aspects in the management of international liquidity, global consistency of macroeconomic policies and financial regulation, which underlie the prevention and management of financial cris4es, as well as in the areas of finance for development and the resolution of outstanding debt issues.

Six areas are the most relevant:

Improved consistency of macreconomic policies at the global level;

reforms of the IMF aimed at providing adequate international liquidity in times of crisis;

the adoption of codes of conduct, improved information, and financial supervision and regulation at national and international levels;

the preservation of autonomy for developing and transition economies with regard to capital account issues;

the incorporation of internationally sanctioned standstill provisions into international lending; and

the design of a network of regional and subregional organizations that support the management of monetary and financial issues.

FINANCIAL INTEGRATION: CONCLUDING REMARKS

How great the impact of capital inflows will be depends on domestic policies of all kinds. For example, the greater are the reliance on short-term external capital, the degree of stock market integration and the openness of the capital account, the greater will be the internal impact of external shocks. Of course, external vulnerability is exacerbated when macroeconomic fundamentals are neglected.

Even when the macroeconomic basis is solid, it is impossible to insulate an economy

completely from the impact of international financial events, given that the financial markets have a tendency to over-react, accentuating cyclical swings and the vulnerability of the real economy to financial movements. External capital can help growth with price stabilization, but it can also exaggerate swings, causing activity and employment to fall and forcing wage and price adjustments in cases where economic expansion has relied too heavily on short-term external capital.

Short-term financial markets make few distinctions within a given region and have a strong tendency to lead cycles. They finance excessive spending, exacerbating imbalances, but tend to withdraw at the first sign of external crisis, creating liquidity crises and exposing the fragility of balances that are reliant on short-term capital. Consequently, there is less external revenue available when action has to be taken to correct errors in economic policy, and this exacerbates the adverse impact.

Access to international financial markets for the economies of the region is an opportunity which can the better be taken advantage of the more domestic economic policy concerns itself with:

i) **Applying policies that promote domestic saving**, both public and private, and seeking to ensure that these resources are largely channelled into efficient investments that enhance international competitiveness and growth potential. For this to happen, these resources need to be absorbed in the context of an export promotion policy upheld by a realistic and stable exchange rate and complemented by adequate technological and human resources development. This would make it possible to generate sufficient external resources for future debt crises to be avoided.

ii) **Securing stable access to external capital flows**, thus preventing these from having a distorting effect on key prices in the economy, such as the exchange rate and the interest rate. The exchange rate must be at a level that stimulates the international competitiveness of the production system; real interest rates, while they should not be such as to generate an excessive level of aggregate demand, should be kept at fairly low levels to provide an incentive for private investment from within the country, reduce insolvency risks in the financial system and avoid macroeconomic distortions. A number of countries in the region have opted for two-pronged intervention in the currency and money markets, combining this with other measures such as legal reserve requirements and taxes and other hindrances to movements of short-term capital.

iii) **Strengthening prudential supervision and regulation of financial institutions**, particularly of a prudential type, to ensure that the increase in assets and liabilities produced by external flows does not threaten their future solvency. It is also advisable for financial markets to be strengthened by developing their long-term segment and reducing the effect of segmentations so that resources can be allocated effectively in accordance with cost-benefit project evaluation.

iv) **Improving statistical information on external flows** (types of flow, volumes, costs and sources), and on the accumulation of stocks of external liabilities in the domestic financial market.

In the sphere of international economic policy, the countries of the region should give consideration to measures that can have an effect in improving the level and quality of external flows. Among these, mention may be made of:

a) **Participation in international discussions on financial regulation.** There are various world discussion forums, such as the International Organization of Securities Commissions, and industrial country forums, such as the Basle Committee on Banking Supervision, which establish rules designed to reduce systemic risk or protect investments. The Central Banks and governments of the region should participate actively in these, since a lessening of systemic risk is of direct benefit to countries that have traditionally been particularly vulnerable to international financial instability.

b) **Participation in discussions on coordination of macroeconomic policies.** Although it is true that macroeconomic coordination between the main industrialized economies has not proved very successful, it is no less true that macroeconomic conditions in these economies still play an important role in international investment decisions. Given this, the governments of the region should not discard the opportunity of making known their concerns and points of view to the authorities of the main industrial countries, particularly as regards the possible repercussions of their macroeconomic policies in the economies of the region.

c) **Greater transparency of information.** The sustainability of external flows would be improved if a freer and more constant flow of information were made available in the region in relation to changing market conditions and current assessments of regional risk.

d) **Encouragement for the establishment of multilateral financial security networks.** In a context of increasing financial globalization, there is a growing likelihood of systemic risk in the international financial system. It would therefore be advisable to take steps towards the establishment of a multilateral financial security network capable of preventing crises, and of administering them more effectively if they do arise. This would involve strengthening the role of multilateral financing institutions in terms of both resources and of their ability to react flexibly to situations of emergency and to enhance their influence on macroeconomic coordination between the main industrialized economies.

e) **Regional financial security networks**
It would be very beneficial for the countries even to anticipate the construction of multilateral financial security networks, as the perception of regional risk would diminish if the region's central banks committed themselves to support one another; this support would include tracking and monitoring of short-term capital, and transparent public information. To be admitted to these networks, the countries should have to undertake to make progress in publishing reliable statistics in a timely way (international reserves, capital movements, fiscal statistics, etc.).

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