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Part Two

CONCLUSIONS AND POLICY CHALLENGES

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Rapid integration into the world economy, followed by many developing countries as a key element of their economic reform agenda since the mid-1980s, has not had the expected developmental effects. Their increased exposure to international market forces and competition has not enabled these countries to establish the kind of virtuous interaction between international finance, domestic capital formation and export activities that underpinned the successful catching up of Western Europe after the Second World War and of the NIEs during the 1980s and early 1990s. In this context, a fundamental question is how to reinforce coherence between national development strategies and global processes and disciplines, as well as policy coherence among and within the various aspects/sectors of the global economy that impact on development prospects of developing countries. Of particular importance is the interface between the international trading system and the international monetary and financial system.

A key objective of the initial set-up of the post-war multilateral trading system, which adopted the tariff as the only legitimate trade policy measure, was that the allocation of resources on the basis of comparative advantage should not be distorted by selective government intervention. The principle of unconditional, non-discriminatory treatment was an essential component of the tariff-based system. It ensured that all signatories to the GATT would be subject to the obligations resulting from multilaterally negotiated tariff concessions, thus imparting a greater degree of security to the concessions. Special and preferential treatment and other trade preferences in favour of developing countries constituted a variation of, but not a departure from, the basic principle underlying this approach.

The adoption of the tariff as the only legitimate trade policy measure was predicated on the belief that, in conditions of strictly limited private international capital flows, setting-up a new international monetary system on an intergovernmental basis with convertible currencies at fixed, but adjustable, exchange rates would provide a stable monetary environment conducive to trade and investment. Accordingly, it was expected that participants in international trade negotiations would be able to predict the full extent to which the competitive position of domestic industries would be affected by tariff cuts without having to be unduly concerned with other exogenous factors.

This assumption does not hold in the presence of sizeable exchange rate volatility, which in developing countries has taken the form of sharp and abrupt real currency depreciations typically preceded by large shifts in expectations of international portfolio investors, in turn resulting in a sharp and abrupt change in the direction of short-term international capital flows. While the trade performance of developing countries generally

improves after “normal” depreciations, major real currency depreciations do not result in proportionally larger improvements, as such depreciations tend to undermine the ability of exporters to take advantage of the rise in international cost competitiveness resulting from them.

In effect, volatility in international financial markets and particularly in short-term private capital flows can reduce international competitiveness and the profit incentive for investors to undertake productivity-enhancing investment in developing countries.[1] Hence, there is inconsistency in the policy advice that encourages developing countries to adopt rapid financial liberalization and yet to increasingly rely on productivity-enhancing investment to strengthen their competitiveness for improved trade performance.

More generally, existing modalities in the multilateral trading system do not address the problems of trade performance that originate in the monetary and financial system. Moreover, there are no mechanisms under the existing system of global economic governance for dispute settlement or redress regarding these impulses. One possible approach to this situation could be a review of the balance-of-payments provisions of the GATT. Articles XII and XV of the GATT 1994 allow a Member to suspend its obligations under the Agreement and to impose import restrictions in order to forestall a serious decline in, or otherwise protect the level of, its foreign-exchange reserves, or to ensure a level of reserves adequate for implementation of its programme of economic development. The provisions of Article XV are directed particularly at payments difficulties arising mainly from a country’s efforts to expand its internal market or from instability in its terms of trade. These provisions are designed to prevent situations whereby countries are forced to sacrifice economic growth and development as a result of temporary difficulties originating in the current account of the balance of payments. The issue could be explored whether they could be used also to address problems associated with instability in financial flows (i.e. the capital account of the balance of payments).

Otherwise, developing-country policy-makers who have adopted financial liberalization at an early stage of their integration process may have to consider adopting measures designed to limit the impact of short-term private international capital flows on exchange rate movements that adversely affect their country’s balance of payments and the international competitiveness of its exporters. This implies that real exchange rate changes, which determine changes in the competitiveness of the economy as a whole, will not be left to the market alone. Many of the particularly vulnerable developing countries will continue to manage the exchange rate of their currencies unilaterally. As this is a promising strategy only if the currency is undervalued and the country records current account surpluses, there is a latent risk of competitive devaluations and destabilizing shocks both among developing countries and in relation to the developed world.

The changes required in the international trading, monetary and financial systems to enable a more equitable distribution of the benefits from international trade and to maximize the developmental effects of globalization for developing countries call for an integrated treatment of trade problems and the increasingly interlinked issues of development and overall payments balances. One major implication of this approach is that decisions on the international monetary and financial system should not be circumscribed by the perspectives of narrow monetary and financial considerations, and should assume the fact that they have strong and lasting impact on the real sectors in both developed and developing countries.

As discussed in chapter III, the architects of the post-war international economic system already attempted to establish mutually supportive systems governing international trade, monetary and financial relations to ensure high and stable levels of activity and employment, financial and exchange rate stability, and the participation of all countries in the benefits from the growth of international trade. This institutional project has never been completed.

While not being a substitute for arrangements that manage international trade, monetary and financial flows interdependently and on the multilateral level, ensuring sufficient policy space has become the chosen strategy of more and more developing countries. East Asian countries pioneered this approach. They did not apply the “open

capital market strategy" at an early stage of their catching-up process, and they tried to avoid dependence on foreign capital flows. This has allowed them to control the real exchange rate, a key determinant of exporters' international cost competitiveness, and the real interest rate, a key determinant of domestic investment, simultaneously.

In the Asian case, the management of the labour market and to a large extent the capital market remained in the hands of national Governments. By adjusting nominal wages to productivity and by influencing the movements of the exchange rate, governments expanded national policy space inasmuch as they reduced their dependence on foreign capital. If governments can prevent a dramatic deterioration in the international competitiveness of a large number of domestic companies, the gains resulting from a favourable investment climate in terms of lower interest rates and higher profits may far outweigh the losses resulting from lower inflows of foreign capital and higher imports.

By the same token, simultaneous opening up of domestic markets to both foreign goods and international capital flows, especially when it is done on a unilateral basis, may cause domestic production capacity to shrink and thus do little to create effective market competition. In such cases, policies to promote the creation of new competitive firms may require active monitoring by the government of the effects of opening up and the possibility of slowing down the process in situations where domestic firms are in danger of being wiped out. Further, the process of opening up has to be supported by policies to strengthen the domestic supply capacity at the national level and to ensure access to the most important export markets at the international level. But even supply capacity and market access may not be sufficient for reaping the benefits of an improved division of labour if there are not enough firms that have a competitive edge resulting from niche production, low production costs or a low exchange rate valuation. ■

Note

1 Moreover, according to Gourinchas and Jeanne (2004: 23), "it has been argued that far from inducing discipline, the disruption induced by capital flows could have deleterious effects on domestic institutions, policies, and growth."

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