

December 11, 1998

MEMORANDUM FOR DISTRIBUTION

FROM: LAEL BRAINARD

SUBJECT: Background Paper for Small Group Meeting on Financial Architecture

Attached is the background paper for the meeting on financial architecture in Room 231 at 4:00 pm, Monday, December 14.

- Secretary Rubin's Memo to the President
- The US Proposal on Tietmeyer
- US Proposal on Regulation
- Process note that went to G-7
- Summary Note
- Summary of Barry Eichengreen's Toward a New International Financial Architecture

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 10, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin *R. E. R.*
SUBJECT: A New International Financial Architecture

At Treasury we have been giving a great deal of thought to the question of the new financial architecture. We have consulted closely with the Federal Reserve, market practitioners, leading academics, and our colleagues from other countries – most recently at a G-7 Deputies retreat. This note and the attached paper summarize our thinking to date.

Events in Asia, Russia and Brazil, coming on top of the Mexican problem of a few years ago, point to the need for substantial steps to enhance stability. It is also true that the sense of urgency created by these problems may make it possible to accomplish changes that have been desirable for a long time. As important as strengthening the system is, it is clear to us that very little will happen without American leadership.

The Challenge

As you stressed at the Council on Foreign Relations and in your speech in Tokyo, the central challenge of international economic policy is insuring that global integration does not mean local disintegration. That is, we need to manage the greater global integration made possible by technology, economic development, and the spread of the market system so as to enjoy its benefits while minimizing the disruptions of people's lives that can come in its wake.

As recent events in Asia, Russia and Brazil point out very clearly, this challenge is especially pressing in the financial sphere. It is the global financial system that makes trade and exchange possible, and the flow of capital can have enormous benefits in creating opportunities for growth. At the same time, we have seen recently that the breakdown in the functioning of that system can have great economic, social and political costs.

That is why increasing the robustness and stability of the international financial system has to be a critical priority. Finding the right approaches here – as in other areas of managing international integration – means finding the right balance among three sometimes conflicting objectives: integration, regulation, and national sovereignty.

Giving great weight to any two of these objectives is easy. Pat Buchanan's policies sacrifice integration in order to be able maintain our sovereignty and regulate our markets. Milton Friedman and other conservative economists welcome integration and respect national sovereignty because they approve of the pressure on regulation and taxation caused by competition between jurisdictions. Many idealists, though few practical policymakers, favor much greater global governance and erosion of national sovereignty so as to allow regulation and integration to coexist.

The challenge is properly to balance all three objectives so as to realize the benefits of capital flows, without either giving up nations' ability to set their own course, or setting off a race to the bottom in regulation and taxation as jurisdictions compete to attract capital. Through the first 150 years of our history, similar challenges faced American policymakers as economic integration among the states increased.

Inevitably, the need for balance means a need to find solutions that are flexible and can evolve. Integration cannot and should not be stopped. But it will have to be managed. A smaller world will have to be a world of more common standards, and more international concern and leverage over what would once have been considered domestic policies. But there are limits on the global interference that nations will tolerate. This may in turn limit the pace at which integration can safely increase.

While it is important to avoid blaming the victims of international financial turmoil excessively, it is equally important to recognize that the recent turmoil has had relatively little to do with hedge funds or other large financial institutions shorting currencies or countries, although these institutions may have an effect from time to time. It has had much more to do with countries' own citizens fleeing with their capital, and governments choosing to borrow heavily short term in order to support their currencies or pursue other objectives. It is important, but not easy, to encourage prudent financing practices. Most countries will not welcome our efforts to restrict efforts to lend to them or their companies *ex ante*, even if *ex post* they wish that there had been more regulation. Moreover, we should remember for every bad borrower, there is a bad lender and central to dealing with this problem is improving the inducements to discipline the latter.

What Can be Done?

We believe that it is necessary to work to and through the Cologne Summit on the new financial architecture at three levels.

(1) *Improving the stability of capital flows.* This will require:

- Stronger incentives for emerging market economies to adopt policies that will improve their ability to capture the benefits of the global capital market, while withstanding its risks;

- Incentives in industrial countries to encourage more disciplined investment and credit decisions, and to reduce leverage and limit systemic risk;
- A more effective regime for crisis management that aims to minimize the severity of crises while maintaining incentives for prudent private credit and investment decisions.

(ii) *Refinement of the existing institutional structure.* If one were to redesign the two global financial institutions today, it is doubtful that one would replicate their current governance structures, division of labor, or modes of raising capital. However, it is also doubtful today that one would be able to obtain political support for the creation of two institutions as ambitious in their conception as the Bank and the Fund. This is something we need to bear in mind as we proceed with institutional reform.

(iii) *Consideration of reforms to the existing governance structure.* At present the G-7 functions as a kind of steering committee for the international financial system. But the advent of EMU and the increasing importance of emerging markets raise questions about the G-7's composition and its near monopoly over the system. We need to create a process that balances effective leadership, which the G-7 can provide, with the inclusion of other countries which have a stake in systemic stability.

Getting From Here to There

A rough timetable of key steps – past, present and future – to bring about architectural changes along these three dimensions is attached. Obviously, developments will depend on how the current crisis evolves. As the focus broadens from the technical financial side to the more political questions of institutional mandate and governance arrangements, it will be particularly important to have interaction at the Head of State level.

Getting From Here to There

Recent "Architecture" Events

Winter 1998. U.S. calls for a meeting of industrialized and developing country finance ministers (G-22).
Spring 1998. April meeting of Finance Ministers and Central Bank Governors followed by agreement to create working groups on transparency, strengthening national financial systems, and managing international financial crises with increased private creditor involvement.

Summer 1998. Birmingham Summit Communiqué calls for proposals in five key areas. G-7 Finance Ministers agree to report on progress to Heads by end of year.

Fall 1998. President participates in the second G-22 Ministerial. Recommendations from the G-22 working groups, along with the U.S. proposal for a contingent facility, form the basis for G-7 Heads Statement.

APEC calls for a task force to examine proposals to strengthen prudential regulation of financial institutions, including examination of questions related to highly-leveraged and off-shore institutions.

G-7 Deputies, at a recent retreat, discuss various ways to carry forward ongoing work on architecture, as well as substantive elements on the architecture agenda.

Forthcoming Events

Winter 1998-99. Heads receive report of Finance Ministers detailing procedures for taking G-22 and other work forward.

First G-7 Finance Ministers meeting following EMU takes place. May reach agreement on forum for strengthening cooperation on financial stability among international regulators, IMF, World Bank and national authorities in key industrial and emerging market economies.

Sherpa process likely to agree on "architecture" as a major theme of Cologne Summit.

In response to the APEC communiqué and the need to maintain the process of broader consultation started in the G-22, the G-7 Finance Ministers are likely to invite other countries to send representatives to a series of ad-hoc meetings on architectural issues.

Spring 1999. Spring IMF/ World Bank Meetings. Possible emerging markets/ industrial countries ministerial. APEC Finance ministerial.

Summer 1999. G7 Head of State Summit. Opportunity for pointing the way towards reform of the international governance arrangements, procedures for increasing regulatory collaboration, and, possibly, changes in the mandates of the IFIs.

Fall 1999. Annual IMF/ World Bank Meetings in Washington. Implementation of agreements on reform.

Improving the International Financial Architecture

Overview

More than \$1 trillion in private capital has flowed from developed to developing countries since the start of the 1990s, bringing new expertise and new investment to the developing countries, as well as contributing to rising living standards. These flows have also helped to increase returns and diversify risks in the developed countries. Yet for all the opportunities that large-scale capital flows bring with them, recent events have reminded us that they also bring new risks. Financial crises such as those we have seen in Mexico in 1994-95 and, more recently, in Asia and Russia, have inflicted immense economic and social damage on the affected countries, imposed heavy direct and indirect costs on the international community as a whole, and threaten to undermine political support for closer global integration.

In the wake of these crises, we all have a responsibility to build a better world financial system, one more adept at avoiding crises and more effective in dealing with them when they strike. Key elements in such a system include:

- stronger incentives for emerging market economies to adopt policies that will improve their ability to capture the benefits of the global capital market, while withstanding its risks;
- incentives in industrial countries to encourage more disciplined investment and credit decisions, and to reduce leverage and limit systemic risk;
- a more effective regime for crisis management that aims to minimize the severity of crises while maintaining incentives for prudent private credit and investment decisions.

The following sets out how we see the main issues, and what steps should be considered going forward. In some cases, work is sufficiently advanced to press for specific actions. In other areas this note points more tentatively to ideas that should be considered, both in our internal discussions and internationally.

I. Improved policies in developing countries

Better policies in emerging markets are needed to promote their domestic stability and to limit their vulnerability to crises caused by shifts in global capital. We should press—bilaterally and through the international agencies—for the following:

- A. *Sound macroeconomic policies.* Countries need consistent monetary and exchange rate policies as well as fiscal policies that avoid excessive accumulation of government debt.

- B. *Prudent public debt management.* Borrowing short-term, and in foreign currencies, can be very appealing: it appears cheaper and may be easier in the short-run. But too much of this kind of borrowing makes governments and countries vulnerable to sudden shifts in investor confidence. In the long-run it can be very costly. Sound debt management is important to provide some "insurance" against the risk of temporary market disruptions.
- C. *Stronger financial systems.* The following steps could all improve financial systems: adherence to the Basle Core Principles for Effective Banking Supervision (perhaps with higher capital standards to reflect the greater risks in less mature financial systems); adherence to other international standards now being developed, including for deposit insurance systems and financial sector safety nets; greater foreign participation in emerging markets, to spread better regulatory and risk management practices; the development of a better credit culture in the banking system; and prohibitions on directed lending and on "non-arm's length relationships" between lenders and borrowers.
- D. *Stronger legal infrastructures.* The Asian crisis demonstrated that for private markets to work effectively, effective financial regulation must be supplemented by strong legal systems. There must, for example, also be clear and enforceable bankruptcy laws, so that a crisis in a single bank or company can be dealt with before it spreads; sound corporate governance, so that investors' and shareholders' rights are clear; and strong judicial systems, so that laws in these areas can be enforced and disputes settled fairly and expeditiously.
- E. *Development of capital markets in emerging economies.* Greater reliance on equity and other financing that does not result in the build up of excessive debt burdens should limit vulnerability to crises. This could include efforts to develop local/regional capital markets.
- F. *Other measures to strengthen governance and fight corruption.* Corruption can undercut economic performance as well as be corrosive politically. Inefficient economic structures also can contribute to corruption.
- G. *Well-designed social safety nets.* Strong social policies alongside other measures are needed to protect the most vulnerable in society.

In section IV below, some direct steps that countries could consider to limit the buildup of excessive short-term debt are also discussed.

II. Measures to induce emerging market economies to undertake sound policies

Global, private capital markets should play a key role in encouraging emerging markets to strengthen their policy regimes, with investors less willing to lend where policies are poor, and insisting on higher returns to compensate for the greater risk when they do lend. But recent

events have demonstrated that market discipline is often sporadic, with periods of easily available capital and little apparent attention to risks, followed by swift and sudden reversals. Official action is needed to strengthen incentives for creditors and investors to analyze and weigh risks with more discipline, and for emerging market countries to follow good policies.

A. *Developing a comprehensive set of codes and standards of good international practice, against which countries' policies can be judged.*

- We would support a major international effort to develop and agree on international codes and standards across the range of areas now understood to be critical for financial stability. Standards in some areas, such as disclosure of countries' foreign exchange reserves and how these measure up against short-term liabilities, are already close to being agreed and can soon be implemented. In other areas—ranging from bankruptcy regimes to corporate governance, to ways to deal effectively with weak banks before the entire banking system is crippled—much work is still needed before there is sufficient international consensus on standards that can effectively raise the bar.

"1st & 2nd code of conduct"

As standards in these areas are developed and agreed, countries need to be encouraged to adopt and implement them. International agreement on an array of codes of good practice, perhaps with benchmarks for performance, provides a device for doing this. Making explicit which countries conform to which codes, and which fall short, could provide a vehicle for using the market to differentiate among those with stronger and weaker regimes.

There is a variety of ways to promote better practices in emerging economies:

- B. *Giving a higher profile to countries' adherence to international standards*, with greater disclosure and transparency about how countries measure up against such standards. The G7 has proposed, for example, that the IMF publicly and regularly report on countries' compliance with the international data disclosure standards developed since the Mexican crisis. The G22 called for a transparency report to be prepared and published by the IMF on each country. We should press forward with these proposals.
- C. *Stronger international surveillance*. Also key is a strengthening of international capacity to monitor financial systems. This could include a strengthened capacity in the IMF and the World Bank to review country performance, including compliance with new international standards as they are developed. As a complement, some form of new independent international accreditation process, perhaps involving the private sector, could also be explored.
- D. *Financial market access*. We could also explore whether we should seek international agreement to link access to our markets, and those of other major financial centers, to emerging markets' adherence to appropriate international standards. While this could be

a powerful tool, it may be difficult to achieve. Possible measures to consider could include:

- Linking the ability of foreign sovereign borrowers to issue bonds in U.S. and other capital markets to their meeting international standards, e.g. for disclosure.
- Linking the ability of financial institutions to do business in major financial centers to their meeting internationally-agreed minimum standards for disclosure and to adequate home-country bank regulation and supervision.

E. Linking IMF and World Bank finance to adoption of better practices. We could press for adherence to international codes to be part of IMF and World Bank conditionality when they lend money, with an explicit timetable for steps to conform to standards, and perhaps prior actions before a program begins.

F. Technical assistance. The G7 has asked the IMF and the World Bank to develop a strategy to provide technical assistance to help emerging markets improve their capacity to meet stronger international standards. Their work should be coordinated with that of bank supervisors and regulators of financial institutions.

G. Exploring additional ways to create incentives for strong policies before, rather than only after, a crisis. Conceptually, it could be attractive to link treatment of countries in crisis to how they had behaved beforehand, thereby encouraging countries to pursue better policies and avert crisis.

- Creating an on/off switch for favorable access to official financing to countries that have met certain key "qualification" criteria would not be workable. It would be difficult to avoid politicizing the process of qualification; bureaucrats in international institutions are not likely to be better than markets at judging in advance when a country is likely to run into crisis; and the international community will probably choose to help systemically important countries in a crisis even if they failed to "qualify." Moreover, creditors may be less prudent in their lending to countries that have "qualified," in expectations of a bailout.

- But it may be worth considering further work to develop a matrix that shows how countries perform across a range of economic and financial areas. We could explore whether this could be a guide to the terms of official finance provided in a crisis: better performers may, for example, be likely to need less conditionality. We could also explore the possibility of incentives (perhaps including differentiated capital charges, discussed below) for private creditors and investors to pay attention to countries' performance. This would add to the pressure for stronger policies. An obvious question mark over such ideas is why the official

sector should be any better than private rating agencies at predicting a country's vulnerability or resilience to crisis.

III. Measures to induce creditors and investors in industrial countries to analyze and weigh risk appropriately

Measures to induce creditors and investors in industrial countries to act with greater discipline – i.e., to analyze and weigh risk appropriately in their lending and investment decisions – are also needed to dampen investors' tendency to underestimate certain risks during periods of market euphoria, and thus limit the build up of excessive debt during the upswing. Such measures are key if the market is to play its proper disciplining function. Industrial countries as well as emerging market economies should live up to the internationally-agreed standards and codes and be subject to an improved process for international financial sector surveillance.

There are two distinct issues in this area, both linked to measures to strengthen industrial country prudential regulation. The first concerns finance for emerging market economies. The second concerns the broader question of systemic risk in the system as a whole and in major financial centers, highlighted by the near-collapse of LTCM. An international task force to examine measures to promote safe and sustainable capital flows, including questions related to "hedge funds" and off-shore centers, should be set up to take forward work in these broad areas, as called for in the APEC and G7 communiques.

- A. *Strengthened risk management systems.* There is a clear need for increased focus on the quality of risk management systems in financial institutions. These systems should also be systematically stress-tested to show the potential impact of unusual changes in financial markets. Regulators need to consider how best to foster the use of high quality risk management models.
- B. *Greater differentiation in bank capital standards.* A review of the existing Basle Capital standards is already underway. This will consider greater differentiation in the capital charges on different assets and retuning the existing standards, e.g., to address current biases in favor of short-term interbank lending and riskier corporate borrowers. Higher regulatory charges on riskier assets should prompt lenders to demand higher returns and help focus management attention on risky lending. Some argue that if regulatory capital for particular categories of lending is set too high, it could encourage even riskier lending in order to justify the capital cost to banks.
 - Consideration could be given, for example, to differentiating capital charges on the basis of a set of criteria related to risk, such as poorly-regulated or unsophisticated financial systems, or on loans to highly leveraged financial entities.

- The first would require the official community to make more judgements about the riskiness of different countries, which would be both politically and technically difficult. However, a more refined, if admittedly imperfect structure, would be better than the present crude distinction embedded in the Basle standards, which favor loans to OECD countries over loans to non-OECD countries. It could draw on a matrix (see II.G) that measures countries' performance against international codes and standards.

We could also explore whether to seek regulatory and disclosure changes aimed more broadly at reducing leverage and systemic risk in financial markets. The direct regulatory focus here, as in many other countries, is on the health of individual financial institutions. But at times what may be prudent for a single lending institution can turn out to be problematic for the system as a whole, if a very large borrower is able to obtain credit to build up exposures that could endanger broader financial stability. One aspect of this is to seek and publicize information about borrowers' total exposure. For sovereign borrowers, we are pressing for much better data in this area through the Bank for International Settlements (BIS).

Other possible changes would put greater regulatory focus on the systemic risk that can be created by a wide range of institutions, including institutions that are not currently regulated. For example, the regulatory net could be extended to cover all institutions above a certain size. But far-reaching changes would be politically difficult in the United States – indeed, more difficult in the U.S. than elsewhere given the diversity of our existing regulatory structure, and breadth and sophistication of our financial markets.

Measures that have been suggested include:

- C. *Higher overall capital adequacy standards.* If financial institutions are made to hold more capital overall in relation to the total risks in their balance sheet, the total amount of risky lending activity that can be supported by the existing capital base would go down. (Higher capital standards in emerging markets may also be appropriate, even if we do not pursue this in major industrial countries.)
- D. *Broader margin requirements.* Consideration could also be given to whether some existing gaps in the margin system should be closed, and more broadly, whether current margin requirements, e.g. on OTC and listed derivatives, are sufficient. Since in some cases margins can be borrowed, margin requirements may not by themselves decrease leverage.
- E. *Disclosure standards.* Greater disclosure by industrial country banks and investors of their exposure to higher categories of risks could increase market discipline and discourage the buildup of imprudent exposures. Disclosure is not without its difficulties; open disclosure of actual positions could undermine financial markets.

- One potential approach is to demand additional disclosure from the banks and other financial institutions that lend to the highly-leveraged institutions ("hedge funds").
- The G7 has agreed to consider the questions raised by disclosure and transparency standards for highly leveraged institutions themselves. It may be more promising to explore whether to extend to other markets (and encourage in other countries) reporting to regulators of large positions in a particular market.

F. *Measures to limit the scope for off-shore regulatory and tax havens.* Strengthened regulation in major financial centers would be undercut if financial and capital market activity merely moved offshore. This is a very difficult area because effective action would need widespread international agreement. Some possible, but controversial, measures that have been suggested include:

- Preventing major financial institutions from establishing branches or subsidiaries in off-shore centers, so that the financial institutions in such centers have to borrow on the basis of the strength of their own balance sheets.
- Conditioning the access of unregulated foreign financial institutions and hedge funds to the major financial centers on their compliance with key regulatory and disclosure standards.

IV. Limitations on the flow of capital

The recent experience of a number of countries has underscored the risk of capital account liberalization that is not paced to the maturity and development of the domestic financial system and broader economy – and, in particular, the danger created when governments in emerging markets actively encourage risky short-term borrowing. We should consider the scope for developing principles to guide countries that are liberalizing and opening up their capital markets on how to reduce the vulnerability of their financial systems to sudden shifts in capital flows. These could include, for example, a focus on encouraging longer-term, equity financing with an open policy to foreign direct investment.

- A. *Restraints on capital inflows.* A range of possible measures could be considered that may help to discourage imprudent foreign currency borrowing, while relying on market mechanisms to the extent possible. It is worth remembering that most countries that have recently experienced trouble have sought to encourage capital to flow in, rather than tried to deter it.
- Prudential bank standards, such as limits on a bank's open foreign currency positions, if enforced effectively, should reduce the riskier kinds of foreign borrowing by banks.

- Some countries have experimented with regulatory requirements that force their banking systems to maintain "liquidity buffers" to protect against the risk of a sudden shift in funds out of the banking system. Argentina, for example, has required banks to maintain large, liquid reserves against their short-term liabilities, including their short-term foreign liabilities.
 - More controversially, some have suggested wider use of market-based, Chilean-style restraints on all capital inflows to deter short-term foreign borrowing by both banks and domestic corporations. The effectiveness of such controls has been questioned by some, in particular for countries with weaker economic policies than Chile.
- B. *Limits on capital outflows.* Controls on capital outflows differ fundamentally from well-designed restraints on capital inflows, aimed to curb the borrowing that makes countries vulnerable to market shifts. Temporary controls on capital outflows introduced after a crisis has hit, in a general attempt to insulate an economy from the rest of the world, are likely to repel new investment, create inefficiencies, and prove difficult to sustain for long. They may also make more tempting policy errors that will worsen long-term prospects. Only in extreme circumstances, as part of the mechanism of a debt workout when the international community agrees that a country simply cannot afford to pay, is their consideration likely to be justified.
- C. *Reducing the amount of trading activity.* In addition to considering whether measures to help restrain capital inflows make sense, we need to consider whether reducing the amount of trading activity – e.g. as a side effect of higher capital charges or stronger margin requirements, or even, as some have suggested, in response to a tax on trading activity (Tobin tax) – would make the international financial system more stable, or only less liquid.
- Some argue that reducing the overall volume of trading activity would make it easier for countries to adopt policies to respond effectively to crisis, maintain macroeconomic stability and avoid sharp surges in inflows or sudden outflows. Emerging market economies are particularly vulnerable to swings in capital markets.
 - Others argue that limiting trading activity would make it more difficult for markets to allocate risk efficiently. It could reduce the benefits associated with the free domestic and international capital markets, without offsetting increases in stability. Liquid markets may be necessary for successful hedging – i.e., protecting yourself against certain risks. Moreover, a small tax on trading activity, even if feasible, would also be unlikely to deter the major swings in capital flows that occur in a financial crisis.

V. Exchange rate regimes

Devising appropriate exchange rate regimes, both for individual countries and for the system as a whole, is one of the central issues for the international system.

A. *Currency arrangements between the major industrial countries.* The major currencies in the system have floated against one another since the collapse of the Bretton Woods fixed exchange rates in the early 1970s. This has allowed the U.S. and other major industrial nations with floating rates to aim domestic monetary policy principally at domestic objectives, which is appropriate for large economies for whom trade is a relatively moderate share of the economy. But it has also produced large swings in the exchange rates of major currencies, which at times do not seem to have reflected changes in the underlying economic fundamentals.

- These large swings in the exchange rates among the currencies of major industrial countries have led to proposals to create target zones for the three major currencies to limit the size of fluctuations.
- However, we believe that the current system provides the best policy option for the United States and that a shift away from floating rates would likely involve an unacceptable loss of macroeconomic policy flexibility.

B. *Appropriate exchange rate regimes for smaller countries.* Given that large fluctuations between the currencies of major countries economies are likely to continue, that many emerging markets have extensive trading ties to a number of large industrial economies, and that the credibility of the policy environment in many emerging markets will take time to establish, the choice of an appropriate exchange rate for an emerging market economy is particularly difficult. Rigid exchange rates have been a common feature in recent crises, yet most emerging markets have been reluctant to accept the vagaries of a pure float.

- Exchange rate regimes are institutional choices that signal policies, priorities, and commitments. There is not a single exchange rate regime that is best for all countries: rather the choice must be based on a country's circumstances.
- No matter what exchange rate an emerging market economy chooses, it is critical that it be backed by a consistent policy regime. Macroeconomic stability is based on good policies, irrespective of the exchange rate regimes. Adjustable exchange rate regimes can be used to help absorb external shocks, but they cannot substitute for sensible policy making.
- Moving from one exchange rate regime to another, particularly in a crisis, can be particularly destabilizing. A key question is how to reduce the risks associated

with such movements. Countries which have adopted fixed exchange rates to eliminate inflation have often held on to fixed exchange rates for too long.

- In some periods of crisis and financial chaos, experience shows that it may be better to select a regime that is at one or the other end of the exchange rate spectrum, either extremely flexible (a pure float) or extremely rigid, such as a currency board. Such clarity facilitates policy-making during difficult times.
- C. Some have suggested that *more far reaching changes* in the international monetary system could be considered for the longer-term, such as the development of regional currency blocs and/or "dollarization."
- The experience of Europe has shown that both extensive economic integration to support a common monetary and exchange rate policy and a strong political commitment are needed for a successful currency union.
 - Adopting the dollar or another international currency as the legal local currency provides more exchange rate stability than a currency board, but requires an explicit and transparent loss of monetary sovereignty.

VI. Crisis Response

There is a spectrum of crises, from those that stem primarily from poor policies to those that stem primarily from contagion. In practice, most fall somewhere in the middle. A regime for crisis response should provide for some combination of financial assistance and policy changes. The provision of large-scale official international finance raises difficult questions: what criteria should be used for access to large-scale assistance, and on what terms; how should such assistance be linked to private sector involvement; and where will the required resources come from.

- A. *Provision of official finance.* Just as there is a role for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability.
- The proposed new IMF precautionary facility will allow large-scale international assistance in the form of a line of credit with appropriate conditionality rather than a traditional, highly-tranched package, so as to facilitate the rapid restoration of confidence for those cases where problems stem more from contagion than from poor policies.
 - It may often make sense in today's world of large and sudden liquidity needs for more official money to be available up-front in return for more up-front policy change than has been traditional in IMF programs.

The current crisis has suggested that the official community may need, at times, to be able to provide large financing packages to quell potential contagion and instability. The increase in the IMF quota due to go into effect shortly will provide the IMF with an important pool of new, uncommitted funds. The World Bank currently has the capacity to provide additional resources, but its lending capacity is not unlimited. Still, the resources available to the International Financial Institutions in the foreseeable future are dwarfed by the scale of current cross-border capital flows. They are also smaller in relation to world GDP and trade than envisaged at the time of Bretton Woods.

- Some have argued for bolder and politically difficult measures to be put on the agenda, aimed at increasing sharply the available official resources.
 - One such suggestion has been to increase IMF quotas dramatically, perhaps also indexing them to growth of the world economy to assure their continued relevance, and increasing the amount that countries have to pay in and can use in crisis. Currently, countries have the automatic and unconditional right to use their "reserve tranche" or paid in capital, but today this is not a significant benefit in times of financial difficulty.
 - Another possible, but also politically difficult, idea that some have argued for would be to allow the IMF to issue additional SDRs (perhaps at a higher interest rate to discourage unnecessary use) to increase the amount of liquidity in the system.

B. *Private sector involvement.* Private sector involvement in the resolution of international financial crises is critical to the long-run health of the international financial system, both because of limits on the availability of official funds and of concerns about moral hazard – the risk that borrowers and private creditors will take decisions based on the expectation that official intervention will cushion the downside risk. The type of private sector involvement required by the official sector as a condition for its assistance should vary, depending on the nature of the countries' difficulties.

- The theoretical ideal towards which the international financial system should move over time is that private sector creditors and investors should bear as fully as possible the consequences of the risks that they voluntarily assume.
 - We could consider if there are ways to develop the system so that it is clear that investors who have made risky international investments, and earn large risk premiums in the best case, are not repaid in full if a country experiences a crisis that requires official intervention.
 - We need to examine how to avoid creating categories of debt that are treated as senior (paid even when other debts are not being paid) because of difficulties associated with their restructuring. Russia, for example, has

defaulted on wide range of domestic and foreign debts, but Russian authorities currently want to continue to maintain payments on Russian Eurobonds, in part, by using funds obtained from the debt relief granted by other creditors.

- In practice, finding appropriate ways to involve the full range of private creditors in the cooperative resolution of a crisis can be difficult. Concrete options for involving the private sector will continue to need to be explored. Already different models are being developed for different circumstances (Korea, Brazil, Ukraine).
 - It can be difficult to convince the private sector to participate voluntarily – particularly if the relevant private creditors are numerous and diverse.
 - More forceful means, including support for official lending into accumulated “arrears” on private debt payments, could be employed to generate stronger incentives for broad-based private sector participation. But coercive measures risk prompting additional contagion, so they must be used cautiously.
- The expanded use of “collective action clauses” in sovereign bonds issued in offshore offerings also could facilitate the orderly, cooperative restructuring of these bonds. The members of the G-7 have committed to examine whether to introduce such clauses into their own sovereign bonds that are issued in foreign currencies.
- It may also be useful to explore ways to encourage emerging markets to purchase more “insurance” against adverse developments, through contingent facilities and debt contracts that contain contractual arrangements that provide the borrowers with greater payments flexibility.

VII. Social Safety Nets

Possibilities for helping to minimize the social impact of financial crises include:

- A. Granting the World Bank a larger role in the design of international economic policy programs, which would bring both the financial resources and social sector expertise of the World Bank to the table quickly in a crisis.
- B. Development of a code of best practices in social policy, as called for in the G7 statement, which could be drawn upon in the design of IMF and MDB programs.

VIII. Institutional Reforms to Carry Forward the Agenda

It may be possible to obtain consensus for a set of institutional changes that would help both implement our architecture agenda and improve international monetary and financial coordination.

A. *A new financial stability policy forum to improve financial sector policy coordination.*

We are proposing the creation of a Financial Stability Policy Forum that would meet semi-annually to discuss regulatory policy issues in an inclusive forum that would bring together financial regulators, the relevant international organizations and national authorities from both industrial countries and key emerging markets. It would create an informal, cooperative mechanism at the global level to discuss financial regulatory policy issues that affect the international system, replacing the series of ad hoc groups that have been set up over the last few years. We will be discussing this proposal with Hans Tietmeyer, who was asked by the G7 to look into this issue, and other G7 members.

B. *Ways to strengthen the interchange between industrialized and emerging market economies.* The G22 process worked well, as a way of promoting discussion between the G7 and other industrialized and emerging market economies. But some have raised questions about its legitimacy. We need to consider how best to retain the ad hoc and informal nature of the G7 process while including systemically significant emerging markets on a regular basis. Some favor strengthening the Interim Committee of the IMF, where all 182 countries are represented. However, the IMF mandate does not extend to all of the issues – the World Bank also would need to be represented for example – and the present Interim Committee constituencies are not well balanced (Asians are under-represented, Europeans are over-represented). We will need to work on these issues, as well as on how to bring together the IMF and the World Bank with the Basel-based groups.

C. *Redrawing the lines between the IMF and the World Bank.*

- One possible reorganization would transform the IMF into an “International Finance Organization,” responsible for macroeconomic and financial policy surveillance and the provision of financing to systemically significant economies, and the World Bank into a “World Development Organization,” centered around development advice and subsidized lending to the poorest countries. However, this would raise the question of how to draw a dividing line between different categories of countries, and how to avoid duplication of expertise.
- Another proposed reorganization that may be worth exploring would refocus IMF surveillance and program conditionality on exchange rate regimes, balance of payments, macroeconomic policy and the soundness of the financial sector. The IMF would get out of the business of structural reform and subsidized lending, while the World Bank would transfer all responsibility for financial sector surveillance and restructuring to the Fund.

- D. *More dramatic institutional reforms.* Possibilities include merging the IMF and World Bank, or merging the IMF's Interim Committee and the World Bank's Development Committee. Merging the two institutions would create lots of chaos. Merging the Interim and Development Committees is one of the reforms being considered as part of our effort to find constructive fora for interchange between industrialized and emerging market economies.

Strengthening Regulation of Financial Institutions US Proposal for International Task Force

Background/Rationale

The G7, G22, and APEC have all recently called for: further work on the scope for strengthened prudential regulation of financial institutions in industrial countries to promote safe and sustainable capital flows; and examination of the implications of operations of highly leveraged and offshore institutions, including with a view to encouraging offshore banking centers to comply with internationally agreed standards.

In response to this request, the US proposes that a task force be established to coordinate existing work efforts and ensure that there are no gaps in the areas which need to be reviewed. The task force can also bring the findings of the various studies to the attention of high level policymakers in the major market economies in order to ensure that policy initiatives are coordinated among countries and international institutions.

Proposal

Methodology – The task force would identify a set of questions in these areas, including those related to certain private sector financial institutions such as investment banks, commercial banks, securities firms, and highly leveraged institutions, and then identify an appropriate organization to carry forward work on that issue.

Scope of Study – The task force would examine (i) the scope for strengthened prudential regulation of financial institutions in industrial countries to promote safe and sustainable capital flows and to encourage sound analysis and better risk management; (ii) systemic implications of highly leveraged firms, including hedge funds; (iii) appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors; and (iv) measures to encourage compliance by off-shore banking centers with international standards. These efforts would also involve an examination of the advisability of extending the regulatory net to financial institutions which are *not* currently subject to substantial disclosure and regulatory requirements.

Task Force Leadership – The United States proposes that Bill McDonough, the Chairman of the Basle Committee for Bank Supervision, would head the task force.

Composition of New Task Force – Pursuant to the call of the G7 finance ministries for the “appropriate committees headquartered in the BIS” to carry forward the work in this area, we propose that Bill McDonough, as Chairman of the Basle Committee, lead a task force composed of representatives from the Basle Committee, the ECSC, IOSCO, the OECD, and FATF, as well as the World Bank and the IMF. The chairman of the task force would also invite central bank regulators and finance ministry officials from a representative group of major market jurisdictions and emerging market countries. The task force would also consult with private sector officials of the IIF, the G30, the Derivatives Policy Group, and other relevant private sector bodies.

Time Frame — We propose that the task force meet shortly in order to develop a set of questions which members of the task force would address, and identify which international organization would address which issue. The task force would provide the G7 Finance Ministers with the set of questions and the identity of the regulatory organization working on each issue no later than January 15, 1999. The task force would complete its work and deliver its recommendations to the G7 Finance Ministers by the time of the 1999 Spring meetings of the Interim and Development Committees.

Warren Gorlick-12/3/98, #2-6:00
cleared: Bill Murden

International Efforts on Strengthening Regulation of Financial Institutions

I. Statements by Heads of State and Finance Ministers

- A. **October 30, 1998 Leaders Statement on the World Economy** -- Called for further work on *"the scope for strengthened prudential regulation of financial institutions in industrial countries to promote safe and sustainable capital flows, encouraging sound analysis and better risk assessment. Examination of the implications of operations of highly leveraged and offshore institutions, including with a view to encouraging offshore centres to comply with internationally agreed standards."*
- B. **October 30, 1998 Declaration of the G7 finance ministers and central bank governors** -- With respect standards of transparency required by the private sector, called for *"the appropriate committees headquartered in the BIS, in conjunction with emerging market countries, national authorities and other relevant private and public sector bodies, to examine the question of appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors."*

With respect to the stability of the financial system, called for a commitment *"to strengthen, in our own countries, the regulatory focus on risk management systems and prudential standards in financial sector institutions; in particular, examining the implications arising from the operation of leveraged international financial organizations including hedge funds and offshore institutions. Appropriate means should be sought to encourage off-shore centres to comply with internationally agreed standard. We call upon other countries which participate in the global capital markets to take similar action."*

- C. **October 1998 Report of the G22 Working Group on Transparency and Accountability** -- Recommended the creation of a *"working party comprising private sector representatives, international groups and national authorities . . . to examine the modalities of compiling and publishing data on international exposures of investment banks, hedge funds and other institutional investors."*
- D. **November 18, 1998 APEC Leaders' Declaration** -- Called for *"the early establishment of a taskforce including the systemically significant economies to develop practical proposals" with respect to "the scope for strengthened prudential regulation of financial institutions in industrialised economies to promote safe and sustainable capital flows, to encourage sound analysis and better risk assessment; to examine the questions of appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors; and to examine the implications of operations of highly*

leveraged and off-shore institutions."

II. Current Work efforts by relevant international organizations

- A. **G7 Financial Experts** -- Each G7 country agreed to provide a brief description of the existing regulatory requirements applicable to hedge funds. Germany, Canada, and the United States have already distributed their papers. The UK and other G7 have not yet done so.
- B. **The Basle Committee** -- The Basle Committee established a Working Group on Highly Leveraged Institutions, headed by Jan Brockmeijer. The task force will soon issue a report that, among other things, evaluates the potential risks from activities of highly leveraged institutions (HLIs), and also assesses the deficiencies in banks' risk management practices towards HLIs.
- C. **ECSC** -- The efforts of the ECSC are not as far advanced as the Basle Committee. At their December meeting, the ECSC will determine the scope of their work project in this area. It is our general understanding that the ECSC is reviewing some of the systemic implications of hedge fund activities, and is also looking at various regulatory proposals in the disclosure area.
- D. **OECD** -- On November 18, the OECD issued a discussion draft of a paper on the relationship of hedge funds and financial markets.
- E. **IOSCO** -- On December 18, the Technical Committee of IOSCO will meet in order to determine whether it should also study the hedge fund issue. We understand that IOSCO may consider the possibility of studying issues related to the high degree of leverage associated with some hedge funds, whether internal controls are vulnerable to managerial override, and risk assessment issues.

Improving International Financial Regulatory Cooperation and Coordination US Proposal for a *Financial Stability Policy Forum*

Introduction

In its October 3rd Statement, and again in its October 30th Declaration, the G-7 Finance Ministers and Central Bank Governors supported the concept of bringing together:

"the key international institutions and key national authorities involved in financial sector stability better to co-operate and to co-ordinate their activities in the management and development of policies to foster stability and reduce systemic risk in the international financial system..."

US Proposal

In response to the G-7 call, the US proposes a Financial Stability Policy Forum that would meet semi-annually to discuss regulatory policy issues in an inclusive forum. The following provides more detail on a possible approach to implement this concept.

General Objectives: The purpose of the Forum is to create an informal, cooperative mechanism at the global level to discuss financial regulatory policy issues that affect the international system. As a standing body, the forum would replace the series of ad hoc groups that have been set up over the last few years to strengthen the financial system. It has three advantages:

- (a) it serves as a bridge across the various functional groups that already exist (e.g., finance ministry groups, groups of international supervisors, and Basle Committee Liaison Group for regulators and the IFIs);
- (b) it cuts across the various financial sectors (e.g., banking and securities) and addresses the geographic limitations of the regulation of global markets; and
- (c) it brings together emerging market and industrial country officials.

Mandate: The Forum could continue the efforts begun in various diverse groups in recent years. Topics could include, but not be limited to:

- strengthening and, where appropriate, encouraging the development of international best practices and standards;
- promoting the adoption and implementation of such practices and standards;
- periodically assessing the operation of the international financial system as it relates to financial sector supervisory and regulatory policy matters;
- promoting appropriate transparency and disclosure for market participants;
- coordinating roles and responsibilities of member institutions and financial centers (e.g., offshore banking centers) to fill gaps and avoid overlaps; and
- promoting peer review processes where useful.

The mandate would exclude crisis management.

Membership: The Forum would consist of key industrial and emerging market economies. The issue of the size of the group should be examined further, including whether it would be possible to limit the membership to major financial centers and emerging markets. Each country would send representatives of the finance ministry, the central bank, and its financial supervisors. The following international institutions would also be invited: IMF, World Bank, Basle Committee on Banking Supervision, ECSC, IOSCO, and OECD. The level of representation could be at the Deputy or Assistant Secretary level. The BIS would serve as the Secretariat.

Meetings: Meetings would be held semi-annually. They could last 1-2 days and include a session with the private sector. The first meeting could be held in the spring under the chair of the general manager of the BIS. The chair could rotate after 1-2 years.

12/3/98; 5pm; wcm

International Financial Architecture Consultation Process

To respond effectively to the task set out in the October 30 statement to expand our review of architecture issues, we need both to refine G-7 views and consult with emerging market and other industrial economies, as well as appropriate international institutions.

At Lansdowne, we agreed to undertake separate approaches to the short-term process for consideration of architecture issues and the longer-term institutional questions including strengthening the Interim and Development Committees.

The institutional questions are an important element of the work on architecture. A number of proposals have been put forward about how the Interim and Development Committees can be strengthened — and how the IFIs more broadly can be reformed — in order to enhance the current system. While we continue to be skeptical about transforming the Interim Committee into a Council, we are committed to examining a range of options over coming months to come to agreement on the best way forward in advance of the Summit in Köln. We will face a number of difficulties, including: the composition of constituencies; the creation of an independent secretariat; and how to relate additional meetings at the deputies level with meetings of the Executive Board — to strengthen political support for the IMF without undermining the Executive Board.

For the shorter term, we would propose that the work on architecture issues be guided by the following broad principles:

1. The process will be anchored in the G-7, which working at the Deputies level will set the agenda and together convene broader groups for outreach.
2. Outreach to other countries beyond the G-7 should take the form of an inclusive, consensus-building process, without prejudice to any longer term institutional reform.

We envisage an internal G-7 process with Deputies and their deputies meeting as often as necessary to reach consensus and complete the work.

- A first meeting of Deputies would take place at the time of the December WP3 meetings in Paris, as proposed by Jean Lemierre. We will have circulated in advance a short paper drawing together the substance of our discussions at Lansdowne. Central bank deputies could be included in this meeting.
- Further meetings of Deputies could take place as necessary to complete the review, formulate recommendations and prepare a report for Leaders in Cologne.

G-7 Deputies would then convene two meetings/seminars in the first quarter of 1999 (e.g., in January and March, perhaps with one hosted in Japan and one in North America) for the purpose of consulting with others on particular issue areas. The host country would chair each meeting, consulting with the Germans as Summit chair.

- One such meeting could cover the range of financial sector issues (including

strengthened prudential regulation in industrial countries, preparation and implementation of international standards, and stronger emerging market financial systems) – taking into account work underway in a variety of fora, e.g., on hedge funds, cooperation/coordination among regulators and capital standards.

- The other meeting could address ways to prevent and respond to crises, including consideration of lender of last resort proposals and improved methods to promote a greater role for the private sector.
- Invitations to these meetings would be sent to finance and central bank deputies from an agreed list of countries, as well as the IMF, World Bank, OECD, BIS, IOSCO, and Basle Committee.

A list of countries that we may want to include in these consultation is attached.

- The list builds on the twenty-six that attended the October 5 meeting, bringing the total number of countries participating to 32 by adding:
 - four countries that may have something to contribute and have evinced strong interest in participating – Chile, Egypt, Saudi Arabia and Spain; and
 - two countries to ensure that each IMF constituency is represented (Cote d'Ivoire as the largest in the Francophone constituency and one of the largest from the constituency currently headed by Iran – Pakistan, Morocco or Iran).
- We may want to promote some self-selection in order to limit the size of the meetings. One approach would be to ask countries to choose which meeting they wish to attend and/or whether to send a central bank or finance deputy but not both to each meeting.

Discussion of the longer term institutional issues, including possible strengthening of the Interim and Development Committees, would continue in our small group. If appropriate, we could undertake a broader consultation on these issues between the February and April Ministers/Governors meetings.

We will need to come to a judgement on whether and in what form the results of the consultations among the broader group of senior officials should be reported – as well as how to respond to the inevitable requests from non-G7 countries for a broader Ministers and Governors meeting in the Spring.

Australia
Argentina
Belgium
Brazil
Chile
China
Cote d'Ivoire
Egypt
Hong Kong
India
Indonesia
Korea
Malaysia
Mexico
Netherlands
Poland
Russia
Saudi Arabia
Singapore
South Africa
Spain
Sweden
Switzerland
Thailand

Pakistan, Morocco or Iran

300

DRAFT: November 30, 1998

**United States Treasury Note Regarding
Meeting of G7 Deputies and Deputy Deputies
Lansdowne Conference Center, Virginia, November 21-22**

The discussions covered a wide range of issues raised for the international community by the events of the past eighteen months. While not producing a clear consensus on future reforms, there were substantial areas of common ground on the causes of the crisis and on core issues that the review of the international financial architecture would need to address. This note summarizes the main points raised on an unattributed basis.

I. Lessons for Emerging Market Policies

1. Exchange Rate Regimes

There was broad agreement that problems with fixed but adjustable exchange rate regimes had been a central element in nearly all 1990s financial crises and should be a greater focus of international surveillance going forward. However, given the fallibility of judgments about "equilibrium" exchange rates and governments' deep reluctance to follow international advice in this area, there was a question about how this lesson could be translated in practice.

Main points:

- using the exchange rate as a device for disinflation tended to court overvaluation problems because of continued inflation differentials. Even adjustable pegs tended to harden into symbols of the authorities' overall credibility, making early adjustment extremely difficult politically. ("It is better to devalue sooner than later, but it is actually easier for politicians to devalue later, when there is no alternative.") Long experience with a fixed system also heightened the difficulties of establishing a credible alternative regime after devaluation; as, for example, in Indonesia.
- nearly all post-1992 crises had come from the combination of exchange rate misalignments, on the one hand, and on the other, a major weakness in the system -- such as a weak banking system -- that made investors doubt the government's credibility in defending the peg. This gave rise to the suggestion that countries relate the degree of fixedness of the exchange rate to the depth and maturity of the domestic financial system.
- one conclusion drawn was that countries should give up trying to import price stability through the exchange rate and instead seek to target the real exchange rate within a system of "controlled flexibility". The authorities would signal to the market that the

exchange rate would depreciate in line with the inflation differential, and major misalignments resulting from nominal inertia would be avoided.

- on the other hand, it was pointed out that past attempts to target the real exchange rate had not been very successful (many of the recent crisis countries had in fact been on crawling peg regimes). In part this was because the "equilibrium exchange rate" was very difficult to calculate at any point in time and subject to significant real shocks. In addition, such a system did not provide a clear response to *upward* pressure on the exchange rate in periods of rising capital inflows.
- an alternative lesson from recent events was that -- in a world of relatively free capital flows -- countries would increasingly be driven away from the middle ground of fixed but adjustable exchange rates towards the extremes of "permanent fixing" (as with a currency board) or a pure float. All noted that currency board regimes had so far emerged unscathed in the crisis. However, it was considered striking how few emerging economies today opted for the vagaries of a pure float.

2. Strengthening Financial Systems

All agreed that the domestic financial system had been an important factor in the crises in emerging economies, and that greater efforts needed to be made to encourage countries match the openness of their capital market to the robustness of their domestic financial system.

Main points:

- the crises had underscored the importance of countries pursuing a gradual, or paced approach to opening the capital account. In particular, it was argued that countries should begin with those liberalization measures that strengthen the domestic system, such as opening the system to foreign participation. Far from pursuing such a paced approach, it was noted that many of the crisis countries had actively sought out short-term, risky foreign borrowing while neglecting the development of the domestic financial infrastructure.
- countercyclical "taxes" on inflows or prudential standards, to help check excessive short term inflows in the boom years, were also supported by several participants.
- there was agreement that the international community's efforts to encourage improved regulatory and supervisory systems in the emerging economies had not been very successful. This pointed to a need for more "muscular" forms of encouragement, perhaps making use of international "rating" of national supervisory and regulatory systems. However, several voiced scepticism about the capacity to put such a scheme in place very quickly.

- conditioning access to major financial centers on the quality of home regimes was suggested as a more readily available incentive mechanism. However, it was thought that the authorities already did this informally in several countries, and there was a question whether it was important enough to emerging market economies to make a difference.

II. Promoting Safe and Sustainable Capital Flows and Constraints on Suppliers of Capital

1. Private Sector Contribution to the Crises

There was some agreement that the suppliers of capital in developed markets shared some of the blame for the crisis, both in their excessive risk-taking in boom times, and excessive panic afterwards. While curbing the excesses of international credit cycles was clearly desirable, there was some uncertainty as to how this might be achieved.

Main points:

- there had clearly been an element of “innocent” contagion in recent events, notably in the market pressure on Latin America following the Russian collapse, although opinions differed on the relative distribution of responsibility. The point was made that the markets still “attacked countries in the right order”, (ie. with reference to relative policy imbalances).
- while exchange rate misalignments had played an important role in several crises, it was said that countries could now be forced to devalue, even where the rate was not clearly out of line with competitiveness. The international community should insist on countries addressing genuine currency misalignments. But it should also help countries without fundamental imbalances from being forced to devalue by the markets.
- the point was made that the emerging market crises should be considered part of a longer run problem of a “global outburst of liquidity” into emerging market asset markets that had now gone dramatically into reverse. During this period, investors were thought by some to have exercised less prudence in their international lending than their domestic.
- to reduce the scope for such behavior, there was considerable support for changing the Basel risk-weighting system, both to reverse existing biases and to begin to develop greater differentiation in the treatment of emerging market and developed market investments. Possibly, these could be made countercyclical, rising in times of times of heavy lending on the grounds that this was when lending tended to be less prudent.
- there was also a desire to impose greater transparency and disclosure requirements on offshore operations and other nonregulated entities, including hedge funds.

- in addition, the question was raised whether formal rules – imposed *ex ante* – requiring creditors to bear some of the burden of adjustments in the event of crisis might also discourage excessive risk-taking by the suppliers of capital. However, this raised a range of concerns, discussed below (Section III, Part 4).

III. The International Response to Crises

1. Content of Adjustment Programs and the Scope of Conditionality

Debate focused on the perceived flaws in the IMF and World Bank's support for troubled economies and on the inherent conflicts in designing adjustment programs – in particular, balancing the desire to address the structural causes of crises against the need to respect national sovereignty.

Main points:

- some believed that the IMF had focused too much on tightening monetary policy in the Asian programs, particularly Indonesia, and not enough on providing liquidity to restore confidence in domestic financial systems. However, against this had to be considered the hyperinflationary risks of failing to rebuild confidence in domestic assets and the possible need for drastic steps to achieve this in an environment of panic.
- there was some agreement that IFI programs needed to be broader if they were to address the kinds of structural and governance problems that were thought to have contributed to the recent crises. In Russia, in particular, it was noted that the relative allocation of international funds to “macro-stabilization” and “micro-structural” programs had been excessively skewed toward macro measures, in part because of the World Bank's apparent difficulty in finding worthwhile projects to pursue.
- on the other hand, several felt that IMF programs – particularly in Asia – had intruded excessively on the choices of sovereign governments in imposing detailed structural and other reforms that were not directly relevant to the problem at hand. Many Asians, in particular, had felt that the IMF's conditionality had been ideological in imposing a “Washington Consensus” that was not universally accepted.
- in this context it was suggested that one might distinguish the scope of programs from the content. Where basic fiscal/ monetary imbalances were concerned, there were perhaps “not many ways to skin a cat”. But in other areas – for example the Indonesian clove monopoly – there was a question whether it was appropriate for the international community to impose particular choices, however worthwhile these might be thought to be. It was accepted that this needed to be squared with the aforementioned desire to broaden the scope of programs to address governance and related issues.

- the point was made that the unpopularity of IFI programs was perhaps inherent in conditionality, and inevitable where governments had long followed the opposite policies. By imposing such changes, the IMF could serve a valuable function for the G7 and provide cover for difficult but necessary reforms in the recipient countries. However, it was important that the World Bank and IMF maintain a united front and there was a widely-felt concern that the World Bank had not taken sufficient public ownership of joint IMF-Bank programs in Asia when these had come under criticism.

2. Precautionary Mechanisms

There was some agreement on the desirability of "precautionary" and other mechanisms, both to help restore confidence at times of generalized market panic and to provide an incentive for basically sound countries to adjust policy sooner.

Main points:

- recent events had highlighted the value of maintaining relatively high levels of foreign reserves (notably, in the case of Brazil). Several Asian economies were said to have concluded that they should build up very substantial reserve levels to protect themselves.
- given that it is costly for countries to hoard reserves -- and destabilizing for the world system for everyone to be trying to do it at the same time -- there was a question whether there ought to be a general increase in SDRs to provide additional, unconditional funds to fend off contagion.
- however, many felt that the international community was unlikely to support what would be perceived as a major expansion of IMF resources. No amount of reserves would prevent a crisis where monetary and exchange rate policies were unsustainable. And to the extent that countries made use of the new -- unconditional -- liquidity it might simply end up subsidizing bad policy.
- consideration was being given to the possibility of countries "pre-qualifying" for some form of contingent reserve facility from the IMF. However, this raised some of the same concerns about conditionality, not least given the international community's previous difficulties in identifying "model" countries. (It was noted that when a similar facility had been discussed in early 1994, Mexico was considered a prime candidate.)

3. The Scope for a Lender of Last Resort and Private Sector Involvement

There was a widely-held belief among participants that both the practical constraints on international official finance and a concern for moral hazard pointed strongly toward finding more effective ways to involve the private sector in resolving crises. But there was considerable

disagreement about the extent to which this should be determined ahead of time -- and about the scope for a more effective international lender of last resort.

Main points:

- it was suggested that financial crises might be viewed as a continuum, with "pure" liquidity problems at one end, and "pure" insolvency problems at the other. Most tended to be somewhere in between these two and it was possible to draw clear lines between the different types. But the international community needed to retain the capacity to respond to crises that are primarily seen as liquidity crises, even if using this capacity to respond to all crises would be highly undesirable.
- on the other hand, all agreed that moral hazard and basic ethical considerations called for a system that would punish reckless lending. Accordingly, several argued for *ex ante* rules to allow the imposition of temporary standstills and controls on outflows when crisis struck -- to enable orderly work-outs and prevent "irresponsible" creditors being rewarded at the expense of either other investors or the international community.
- however, it was noted that any such measures would bring a range of practical difficulties and also important risks. In particular, there was a risk that imposing any such rule would make crises more likely, by giving investors an incentive to remove their money earlier. In that sense, the problem of finding ways to penalize investors was less a technical problem than a problem of judging how other investors would react.
- against this, it was argued that most developed markets had systems in place for dealing effectively with each kind of problem at the domestic level and it was not obvious why the same two systems could not be constructed internationally. Also, it was said that to the extent that flows to the developing were already depressed, this might actually make it the perfect time to introduce new rules. Even if there were a long-term reduction in flows to the emerging economies, this would not necessarily be such a bad thing given their apparent incapacity to absorb these flows productively.
- moreover, as a practical -- and political -- matter, there was a widespread belief that the international community was unlikely to make available the kind of resources that would be required to have a truly global lender of last resort, especially where this was perceived to serve the interests of irresponsible investors.
- in light of these considerations, it was felt that the treatment of very high-yielding sovereign debt were worthy of particular attention going forward. Such debt played a key role in triggering crises in Russia and Brazil -- neither of which had especially high levels of public debt by international standards -- and could not be said to have been "innocently" taken on by investors.

- all were agreed that it was extremely undesirable for such investors to be fully paid off in countries that are presently, or soon likely to be, the recipients of substantial official finance. However, the extreme hesitance to force private sector rollovers of sovereign short-term debt in the case of Ukraine, a country in which there had been a widely accepted moral hazard element to past lending, was suggestive of the problems involved in applying this principle into practice.

Toward A New International Financial Architecture
A Practical Post-Asia Agenda

Barry Eichengreen
University of California, Berkeley

October 1998

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References

"Some real things have happened lately. For a while we felt rich, and then we didn't. For a while we thought time was money, find the time and the money comes with it...I see now that the environment we were leaving was that of feeling rich. I see now that there will be no Resolution Trust to do the workout on this particular default, but I did not see it then."

Joan Didion
The Last Thing He Wanted
(New York, Vintage Books, 1996, pp.1-2)

"Going forward will not require the kind of far-reaching institutional change that we saw in 1945, but the international architecture does need to adapt substantially for the very different circumstances that have developed over the past decade, and to fully prepare for the challenges of tomorrow. This adaptation involves great intellectual complexities and great international political complexities and will occur not at one time, but in pieces over an extended period."

Robert Rubin
Strengthening the Architecture of the International Financial System
(Treasury News, U.S. Department of the Treasury, April 14, 1998, p.3)

Summary of Recommendations

The current crisis is to those concerned with the operation of international financial markets what the collapse of the Eastern Bloc was to Sovietologists. It has forced old models of the international financial architecture to be abandoned, albeit with reluctance, and prompted some remarkably radical new thinking. The British government proposes merging the International Monetary Fund, the World Bank and the Bank for International Settlements to create a single super-regulator of financial markets. The French government proposes vesting additional decision-making power in the Interim Committee of industrial-country finance ministers that oversees the operation of the IMF, enhancing accountability, eliminating the need for consensus decision making, and allowing the institution to respond more quickly to crises. The German government has mooted the idea of target zones for exchange rates to prevent currencies from misbehaving. The Canadian government proposes incorporating into loan contracts provisions providing for an IMF-sanctioned "pause" or payments standstill to be invoked in the event of financial difficulties. George Soros proposes an international debt insurance corporation, Henry Kaufman an international credit-rating agency, Jeffrey Garten an international central bank, Jeffrey Sachs an international bankruptcy court. The one thing these proposals have in common is their impracticality. They have not a snowball's chance in hell of being implemented. They assume a degree of intellectual consensus and political will that simply does not exist.

My goal here is different. It is to provide a set of practical, limited, realistic proposals for reforming the international financial architecture that actually have a chance of being

implemented. More ambitious schemes at least have the merit of focusing thought on the underlying problem, but they have little chance of making the world a safer place in the time frame that is relevant for practical policy analysis. More than any of the grand schemes enumerated above, my proposals resemble the three reports on reforming the financial architecture issued by the Group of 22 on the occasion of the Bank-Fund annual meetings in October 1998. There is a danger that these reports will sink from sight, like the Group of Ten report on sovereign liquidity crises issued following the Mexican crisis, since they have no single government or multilateral organization behind them.¹ This would be a shame, since these are pragmatic documents containing much sober and sane analysis. I will argue, however, that while they adopt a generally sensible approach to the problem, they do not go far enough.

My conclusions fall under three headings: crisis prevention, crisis prediction, and crisis management.

Crisis Prevention

For financial crises, as for health maintenance, prevention is the better part of cure. There is little disagreement about the steps needed to prevent unnecessary crises. Better information on the economic and financial affairs of governments, banks and corporations will strengthen market discipline (encourage lenders to ration credit to borrowers who fail to take the steps needed to maintain their financial stability) and help policy makers identify the need for corrective action. Upgrading the supervision and regulation of financial markets and especially

¹Group of Ten (1996).

banks will strengthen the weak link in the financial chain. Exchange rate flexibility will encourage banks and corporates to hedge their foreign exposure, enhancing their ability to withstand unexpectedly large exchange rate changes.

Although some progress has been made in these areas, considerably more remains to be done. A first area requiring a major international initiative is international financial standards. In a world of integrated financial markets, international financial stability is impossible without domestic financial stability. Stabilizing the financial system consequently requires institutional reforms extending well beyond policies toward external trade and payments. That it requires rigorous disclosure requirements and effective supervision of banks and corporations borrowing on financial markets is now widely agreed. Some will argue that this is as far as the international community and the IMF should go in intruding into the internal affairs of countries. In contrast to this view, I argue that they must go further -- that the need for domestic institutional reforms with implications for the stability of international financial markets extends well beyond this point. It extends to the use of internationally-recognized auditing and accounting practices so that lenders can accurately assess the financial condition of the banks and corporations to which they lend. It extends to effective corporate governance, so that claimants can monitor and control the economic and financial decisions of managers. It extends to investor-protection laws to prevent insider trading, market cornering and related practices, in whose absence securities markets will not develop. It extends to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. While these are problems for individual countries to address as they see fit, whether they arrive at an adequate solution is also of pressing concern to the international policy community, given the scope for financial

problems to spill contagiously across borders. The inability of countries to reach *national* solutions, in other words, can threaten the stability of the *international* financial system.

This is an ambitious agenda for reform. The fact of the matter is that neither the IMF nor any other international organization has the resources to provide each and every emerging market with advice on every item on this list. The IMF in particular needs to acknowledge its limited administrative capacity. Instead of trying to solve all problems by itself, it is essential that it encourage the promulgation of international standards of acceptable practice by private-sector bodies with expertise in these areas (the International Accounting Standards Committee, the International Corporate Governance Network, and the like) and by international committees of national regulators (the Basle Committee, for example). National arrangements may differ, but countries participating in international financial markets all must meet minimally acceptable standards. The role of the IMF should be to collaborate with these other bodies, to bestow official status to the standards they promulgate, to monitor countries' compliance, to encourage information on that compliance to be disseminated to the markets, and to condition its lending on steps to comply.

A second area where a major new initiative is required concerns banks and capital flows. Recent experience has demonstrated that badly managed banks and open international capital markets are a combustible mix. The most direct way of reducing this danger is to strengthen banks' risk-management practices and supervisors' oversight and regulation of those practices. Everyone agrees on the need for banks to better manage credit and currency risk, on the dangers of connected lending, on the need to insulate supervisory authorities from political influence, and on the need to raise bank capitalization as a way of giving bank owners and managers a financial

cushion and something to lose.² But the sad truth in all too many countries is that banks have a limited capacity to manage risk, while regulators have limited capacity to supervise their actions. And given the political realities, bank capital is all too rarely written down. This means that revising the Basle Capital Standards to key capital requirements to the source of banks' funding as well as the riskiness of their investments is unlikely to prove ineffective. If bank capital is not written down, in other words, how can capital requirements deter excessive risk taking?

In this environment, free access to foreign finance, short-term finance in particular, may be incompatible with financial stability. Foreign funding permits banks gambling for redemption and otherwise seeking to take on excessive risk to lever up their bets. Government guarantees for banks regarded as too big to fail encourage foreign investors to provide those funds. But a disturbance to confidence may prompt these foreign investors to flee at any time, and the short maturity of their loans provides ample opportunity to get out. Their rush for the exits can precipitate a crisis which brings down both the banking system and the currency. This creates a strong argument for limiting or taxing bank borrowing abroad. And where banks and corporates can circumvent these measures by having the corporations do the borrowing and pass on the proceeds to the banks, broader measures may be required. Financial stability may have to be buttressed by a Chilean-style tax to limit short-term foreign borrowing by all domestic entities. The international policy community should be a stronger advocate of the use of such measures. The U.S. Treasury needs to overcome the "Wall Street complex" that renders it reluctant to embrace such policies, and the IMF should make unambiguous its support for the approach.

²See Goldstein (1997), Bank for International Settlements (1997), and Folkerts-Landau and Lindgren (1998).

Crisis Prediction

However extensive progress in these areas, crises will still occur. Sudden reactions to new information, or new interpretations of old information by incompletely informed investors, can still precipitate sharp market moves. Such is the nature of financial markets, or so hundreds of years of financial history suggest. Only placing financial markets in a regulatory strait jacket can prevent this. And such severe repression means foregoing the benefits of domestic financial liberalization. It is a route that virtually no country is prepared to go.

Observations like these have encouraged the official community to invest in "early warning indicators" of currency and banking crises in the hope that they will see what is coming. Unfortunately, these models will have about as much success in predicting financial crises as geologists' models have in predicting earthquakes. Earthquakes and financial crises are products of complex nonlinear systems whose parts interact in unpredictable ways. Consider the following example. The government will devalue the exchange rate only if it fears that the interest-rate increases required to defend it will irreparably damage a weak banking system. But the banking system will weaken to this point only if investors withdraw their deposits from the country because they anticipate a devaluation. Thus, it is equally possible that everyone will wake up tomorrow morning to a strong currency and a strong banking system or to panicked depositors and an incipient devaluation. Ex ante, there is no way of predicting which of these outcomes will obtain.³ Whether speculators attack depends not only on the weakness of a

³This is an example of a so-called second-generation model of currency crises, in which multiple equilibria may arise. This class of models is described in more detail in Appendix 3. As explained in Chapter 5, multiple equilibria of this sort make it more difficult to predict crises with the precision relevant for practical policy analysis.

country's banking system but on how much governments care about further aggravating this problem when deciding whether to defend the currency. And the only thing more difficult to measure than a government's resolve is investors' assessment of it.

It is not surprising, therefore, that there is typically less to these statistical models than meets the eye. The models that perform best rely on reversals in the direction of capital flows and sudden reserve losses, variables that are properly regarded as concurrent rather than leading indicators of currency crises. These models are like Richter scales registering the severity of earthquakes, in other words, not predictive devices.

None of this is to dispute that further work on the causes and consequences of financial crises will continue to improve our understanding of these complex phenomena, just as further research into the interaction of tectonic plates deepen our understanding of earthquakes. But this is a far cry from saying that better economic models will allow us to reliably predict financial crises. There will always be financial surprises — unanticipated crises will still occur, notwithstanding forecasters' best efforts. In addition, there is the danger of Type II error — of warning and in the worst case precipitating crises that would not otherwise occur.

The attractions of this intellectual game are such that it will continue to be played. But this is not where the international policy community's scarce intellectual and political capital should be expended. And there is an associated danger, namely, that early-warning exercises will produce an unwarranted sense of complacency in the official community. They may lull officials into false confidence that they know what is coming.

Crisis Management

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If there will always be crises, there will always be a need to clean up after them. This is where the existing international financial architecture is most obviously deficient. The international community has two basic ways of responding to crises: running to the rescue of the crisis country with a purse full of official funds, or standing aside and letting nature run its course. Both have been tried and found wanting. The first approach was tried in Mexico and Asia. For two years following the Mexican rescue and for fully a year following the outbreak of the Asian crisis, the IMF was subjected to a firestorm of criticism for bailing out governments and international investors. Its actions, in the view of the critics, only reduced the incentives for meaningful policy reform and, by shielding the private sector from losses, encouraged more reckless lending, and setting the stage for more crises. Then in the summer of 1998 the Group of Seven and the IMF denied another official loan to Russia, which was forced to devalue and suspend debt service payments, with a devastating impact on the Russian economy and global financial markets. Confidence was destroyed; Russia's access to international capital markets was disrupted; and financial markets were roiled in East Asia, Eastern Europe, Latin America, and even Europe and the United States. This is not an experience anyone wishes to repeat. One cannot avoid concluding that both alternatives — bailouts on the one hand, standing back and letting events run their course, on the other — are unacceptable.

Avoiding both routine rescues and devastating defaults will require creating a more orderly and efficient way of restructuring problem debts. Under present circumstances, restructuring is too difficult and protracted. It *should* be difficult to some extent, or borrowers would find it too easy to walk away from their debts. But the point here is that the difficulties of restructuring are much greater in international than domestic markets and that this problem needs

to be corrected. Capitalism without bankruptcy is like Catholicism without sin, it is said, but the sovereign bankruptcy option is simply too costly to contemplate under present institutional arrangements. Radical reform of those arrangements -- creation of an international bankruptcy court -- is patently unrealistic. Discussing these ideas is a waste of breath. Yet something must be done to create an acceptable alternative to massive international rescue packages.

In fact, a number of modest and realistic steps might be taken to make international debt restructuring a viable option. Majority voting and sharing clauses could be added to loan contracts. This would prevent isolated creditors from resorting to lawsuits and other means of obstructing settlements that improve the welfare of the debtor and the vast majority of creditors alike. Other desirable changes to loan contracts include collective representation clauses (making provision for an indenture trustee to represent and coordinate the creditors in the case of sovereign debts) and clauses providing that a minimum percentage of bondholders must agree in order for legal action to be taken. The addition of such clauses to bond contracts is the only realistic way of creating an environment conducive to flexible restructuring negotiations. It is infinitely more realistic than imagining the creation of some kind of super-national bankruptcy court for sovereign debts empowered to cram down settlement terms.

In addition, standing committees of creditors should be created to provide better communication between lenders and borrowers, jump-starting negotiations and diminishing the information-asymmetries that encourage the two sides to fight a protracted war of attrition. Under special circumstances, the IMF could lend to countries in arrears on their external debts, providing the equivalent of the "debtor-in-possession" finance available to U.S. corporations under Chapter 11 of our bankruptcy code. Not only will this working capital keep the crisis

economy running, but it would encourage the creditors to come to the bargaining table, again working to speed restructuring negotiations. And when the problem is defaulted corporate and bank debts, the solution lies not unrealistic designs for an international bankruptcy court but in strengthening national bankruptcy statutes, reinforcing the independence of the judicial system administering them, and harmonizing those laws across countries.

Few of these recommendations are new. Both new provisions in loan contracts and IMF lending into arrears were discussed in the 1996 Group of Ten report. The need for creditors' committees was developed in a background paper for the Group of Ten's deliberations commissioned by the Bank of England and UK Treasury.⁴ Unfortunately, those discussions were not followed by action. Officials imagined that the markets would be so impressed by their insights that they would rush to amend loan contracts, form creditors committees, and endorse IMF lending into arrears. Predictably, little happened over the subsequent two years. No country is prepared be first to add sharing and majority voting provisions to its loan contracts for fear of sending a bad signal to the markets; this is something that will happen only if everyone moves together. The markets are reluctant to form standing committees of creditors for fear that deciding who will be on the other end of the line will make it too easy for the financial distressed to pick up the phone. These recommendations have now been repeated by the G-22, but words need to give way to action. Regulators, led by those in the advanced industrial countries, should require that internationally traded securities include majority voting, sharing, non-acceleration, minimum-legal-threshold, and collective-representation clauses. The United States, the G-7 and

⁴Eichengreen and Portes (1996).

the IMF need to press for the formation of creditors' committees. The IMF should test the market's reaction to lending into arrears when an appropriate occasion arises.

Even together, these measures will not create the ideal orderly-workout system. But they are the only practical alternative to pie-in-the-sky schemes for radically remaking the international financial world and assuming a political and economic consensus that does not exist. If we wish to create a viable alternative to massive bailouts and devastating defaults, they are the only game in town.

Implications for the IMF

The IMF will still have a role to play following these changes in the international financial architecture. There will still be a need for it to provide financial assistance, ideally in conjunction with credit lines extended by commercial banks, to countries running fundamentally sound economic and financial policies but suffering a temporary loss of investor confidence. But it will have to become less of a fireman and more of a policeman. It will have to police countries' conformance with international standards in areas related to the operation of financial markets. This means working with private sector bodies and international committees of regulators in establishing those standards, monitoring the compliance of its members, and informing the markets of their progress. It implies more systematic collaboration with the private sector and other international organizations than heretofore.

In addition, the Fund will have to become increasingly active as the facilitator or coordinator of restructuring negotiations. Playing the role of honest broker, it will have to bring debtors and creditors together like the New York Fed did for Long Term Capital Management

and its bank creditors in September 1998. But while supplying a conference room and hinting that accommodation is desirable, this will not be enough, given the special difficulties of restructuring international debts and sovereign debts in particular. In addition, the Fund can more forcefully encourage the parties to come to the bargaining table by lending into arrears when the appropriate occasion arises. And it can use its position at the center of the international financial stage to push for the institutional reforms needed to create a viable alternative to ever-larger bailouts. It can insist on the creation standing committees of creditors and, if necessary, provide incentives for their formation by agreeing to regular meetings at which it and private creditors are prepared to exchange views. It can lobby for the addition of innovative clauses in loan contracts designed to smooth the restructuring process and lend at lower interest rates to countries that adopt them.

All this presupposes that the Fund will clean up its own act. The institution has acknowledged most of the obvious needs and moved some distance in the requisite direction by strengthening its surveillance of financial markets, promoting the dissemination of information, and releasing more documentation on its programs and decision-making process. But these are the uncontroversial decisions. The heavy lifting will be for staff, management and directors to reach a consensus on what kind of macroeconomic and financial policies to recommend to its developing-country members, given the realities of today's immensely-liquid and not always reliable capital markets. Countries need to do more to protect themselves against the dangers posed by those markets, and the IMF needs to do more to encourage them. As noted above, the Fund should actively encourage countries in which banks have limited ability to manage risk and regulators have limited ability to supervise their actions (in other words, in the vast majority of

its members) to use Chilean-style holding period taxes to discourage excessive short-term capital inflows, and it should unambiguously press for the adoption of more flexible exchange rates by most of its developing-country members, especially by those with open capital accounts. The first measure is needed to prevent borrowers who might otherwise be regarded as too big to fail from levering up their bets, the second as an incentive for banks and corporates to hedge their foreign exposure so that they can cope with unexpected large exchange rate movements if and when they occur. These are not areas where there yet exists a consensus within the IMF or among its principal shareholders. Until there does, the Fund will be part of the problem, not part of the solution.

Standards for Crisis Prevention

Once upon a time, long, long ago in a place far, far away, crisis prevention and crisis management were so straightforward that they could be delegated to macroeconomists. Currency crises were caused by recklessly expansionary monetary and fiscal policies that resulted in excess demand, overvalued exchange rates, and unsustainable current account deficits. Preventing them meant restoring monetary and fiscal balance before these excesses got out of hand. For the IMF, crisis management meant providing temporary financial assistance so that the macroeconomic retrenchment necessary for the elimination of current account deficits did not unnecessarily produce or aggravate recessions. It meant conditioning that assistance on the restoration of monetary and fiscal discipline. It was not necessary for those whose objectives were the maintenance of exchange rate and financial stability to concern themselves with a country's financial nuts and bolts -- with its bank supervision and regulation, auditing and accounting, bankruptcy procedures, and corporate governance. One can question whether things were ever so simple, but there is some truth to the view that for its first half-century the IMF rightly focused on countries' monetary and fiscal policies and was only tangentially concerned with their internal institutional arrangements.

In Asia (and, for that matter, in its other recent programs), the IMF has become more deeply entangled in countries' internal affairs. It has sought to promote good governance, encouraging the authorities to improve prudential supervision, root out corruption, eliminate subsidies, break up monopolies, and strengthen competition policy. In virtually every program country, this has incited a backlash against the Fund, which is resented for its intrusiveness.

Martin Feldstein and others have questioned whether such intimate involvement in the internal affairs of sovereign states is necessary for the restoration of currency stability.¹ What business is it of the Fund, Feldstein asks, to demand that Indonesia scale back its national car program or break up its clove monopoly? The IMF, he contends, should focus on the monetary and fiscal imbalances that are at the root of balance-of-payments problems. Not only does the Fund lack a secret formula for how every country should organize its internal affairs, but its advice is more likely to receive domestic backing and to be sustainable politically if it avoids infringing unnecessarily on the sovereignty of its clients.

At the same time, this view sits uneasily with the fact, widely acknowledged, not least by Feldstein himself, that monetary and fiscal profligacy was not widespread in Asia in the period leading up to its crisis. Since monetary and fiscal excesses were not at the root of the crisis, how then can it make sense to recommend focusing on monetary and fiscal variables when devising a response? The problem and the solution must lie elsewhere.

A hint to its location follows from the observation that high international capital mobility has all but erased the line between the domestic and international financial systems. This makes it impossible to "fix" the *international* balance of payments without also "fixing" the *domestic* financial system. So long as the domestic and international financial systems were strongly segmented by capital controls, balance of payments deficits arose out of current account deficits that were financed with international reserves. Restoring balance of payments equilibrium meant restoring balance to the current account, which implied the need to restrict monetary and fiscal

¹See Feldstein (1998).

policies. But now that capital is so mobile internationally, stabilizing the balance of payments means stabilizing the capital account, which requires restoring investor confidence. And restoring investor confidence means restoring confidence in the stability of the domestic financial system.²

Inevitably this draws those seeking to prevent and limit the severity of crises into involvement in the supervision and regulation of banks and corporates issuing publicly-traded securities. It directs attention to auditing and accounting practices, the disclosure of financial information, and corporate governance. Recent models point to banking system weaknesses, the opacity of balance sheets, and moral hazard from government guarantees as the causes of currency and financial crises. Guarantees encourage excessive foreign short-term funding of the banking system, while directed lending leads banks to invest in low-return projects that damage their balance sheets. The fragility of the financial system then prevents the authorities from mounting a concerted defense of the currency. Inadequate auditing and accounting practices prevent investors from distinguishing good banks from bad and set the stage for economy-wide banking crises. Similarly, poorly designed or enforced insolvency procedures can precipitate creditor grab races and cascading debt defaults. If this view is correct, it suggests that fundamental institutional reforms are needed to root out the causes of financial crises.

The problem is that neither the IMF nor other international financial institutions have

²In the language of Appendices 2 and 3, the balance-of-payments disequilibrium reflects not a flow problem (that the flow of government expenditures and the flow supply of new domestic credit emissions exceed the current period's additions to demand), as in first-generation crisis models. Rather, it is a stock problem, in which investors skeptical of the liquidity or solvency of the banking system have to be induced to hold the outstanding stock of bank liabilities rather than shifting into foreign exchange.

sufficient staff, much less staff with sufficient expertise, to proffer advice in all these areas. The Fund cannot realistically aspire to master the regulatory particulars of banking systems in all 182 member countries. Hiring or borrowing bank supervisors from those member countries would simply remove them from where they are needed most urgently. The problem grows more severe when one turns from bank regulation to auditing and accounting, insolvency codes, and corporate governance, issues in which macroeconomists have little formal training or experience.

At the same time, problems in these areas are too pressing to do nothing. The response to those who say that financial supervision, auditing and accounting, insolvency and reorganization procedures, and corporate governance are mere window dressing is that adequate institutional arrangements in these areas are essential to financial stability in our modern world. If the Asian crisis has taught us one thing, it is that countries cannot restore exchange-rate and balance-of-payments stability without rectifying deficiencies in their domestic financial systems.

The Standard Solution

The only feasible approach to this problem is for national governments and international financial institutions to encourage the public and private sectors to identify and adopt international standards for minimally acceptable practice. National practices may differ, but all national arrangements must meet minimal standards if greater financial stability is to be achieved. All countries must have adequate bank supervision and regulation. All must require financial market participants to use adequate accounting and auditing practices. All must have transparent and efficient insolvency codes. The particulars of these arrangements can differ—countries can reach these goals by different routes—but any country active on

international financial markets needs to meet internationally accepted standards.

An advantage of this approach, along with its ability to accommodate variations in national traditions and economic cultures, is that responsibility for setting the relevant standards does not fall primarily on the IMF, multilateral institutions in general, or even national governments. In many cases, the relevant standards can be identified or defined by private sector bodies. Although those entities can be aided in their work by officials, the role for international institutions would be limited to recognizing those standards, urging adoption by their clients, monitoring compliance, and — in the case of the IMF — conditioning international financial assistance on a commitment to meeting them.³

In many of these areas, the relevant private-sector body already exists. In accounting there is the International Accounting Standards Committee (IASC), consisting of representatives of the accounting profession from 91 countries, which promulgates international accounting standards.⁴ There exists the International Federation of Accountants, with parallel membership,

³The approach advocated here is very different from that suggested by, inter alia, Richard Dale (1998), who suggests — unrealistically in my view — that responsibility for international standard-setting and enforcement (in Dale's case, in the areas of banking and securities market regulation) should be lodged in a single agency. Similarly, Kaufman's (1998a,b) idea that a new international institution should be created to establish uniform capital standards and trading, reporting and disclosure standards and to monitor the performance of financial institutions and markets is similarly unrealistic; there would be strong resistance, and not only in the U.S., to the idea of vesting such formidable powers in the hands of an international institution.

⁴The objectives of the IASC as stated in the Committee's constitution include formulating and publishing "accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance....," emphasis added. Quoted from the IASC's web site (<http://www.iasc.org.uk>). 33 standards have been issued since 1974.

which has gone some way toward formulating international auditing standards.⁵ The International Organization of Supreme Audit Institutions (INTOSAI) similarly issues auditing guidelines and standards. Committee J of the International Bar Association is developing a model insolvency code designed to guide countries seeking to reform and update their bankruptcy laws. For corporate governance there is the International Corporate Governance Network (ICGN), which seeks to improve standards of business management and accountability worldwide.

In other areas, responsibility for setting standards has been taken on by international committees of regulators. In securities-market regulation there is the International Organization of Securities Commissions (IOSCO), which serves as a forum for securities regulators and has established working groups to set standards and coordinate regulatory initiatives. For bank regulation there is the Basle Committee on Banking Supervision, made up of bank supervisors from the leading industrial countries. But even in these areas where regulators have taken the lead, there is a role for the private sector. Thus, the Group of Thirty has recently recommended that the world's largest financial institutions develop standards for monitoring and managing financial risks.⁶

Multilaterals are already active in a number of these areas, helping to identify standards or coordinating the process through which others agree to them. Thus, the Organization for

⁵In addition, the Federation, in its discussions, has paid special attention to the role that sound accounting practices can play in the development of capital markets in emerging economies.

⁶Group of Thirty (1997).

Economic Co-operation and Development (OECD) issued a report in 1998 on global principles of corporate governance, focusing on the accountability of management, disclosure and transparency, and communication with shareholders.⁷ The United Nations Commission on International Trade Law (UNCITRAL) has adopted a model law on the treatment of cross-border insolvencies. The IMF, as described below, has established a Special Data Dissemination Standard for the provision of economic and financial information by countries seeking to access international capital markets and has promulgated a code of fiscal transparency (complete with handbook) to be adopted as a standard of good fiscal practice by its member countries. In all these cases, the multilaterals have solicited guidance and advice from national officials and private-sector experts.

One could contemplate a sequence of increasingly ambitious steps toward creating a more active role for the IMF and other multilaterals in the areas of standard setting and dissemination. Least ambitious would be for them to simply observe and encourage the activities of these groups. Somewhat more ambitious would be for the IMF and other multilaterals to actively consult with these groups (as the Fund already does with IOSCO and the Basle Committee), to seek status as an ex officio member, to certify the standards they identify as measures of best practice, and to recommend that their members commit to meeting them. The Fund should clearly condition the disbursement of financial assistance on program countries making progress in meeting those standards. More ambitious still would be for the Fund to actively encourage countries to apprise the markets of their compliance. The IMF could monitor countries'

⁷OECD (1998).

compliance with those standards, for example in conjunction with its Article IV surveillance. Most ambitious of all would be for a multilateral like the IMF to make public its assessment of compliance as a way of attempting to strengthen market discipline.

A more active role for the IMF and the other international financial institutions in the promulgation of standards would be a departure from past practice. But it is the only alternative if one believes that action is essential but that the Bretton Woods institutions do not possess the resources to develop standards in all these areas themselves. The process will be complicated, but the alternative — inaction — is no longer viable. If it is necessary to proceed, there is no alternative to proceeding by way of public-private sector collaboration.

Some Examples

Examples of this process are standards for bank supervision, securities market regulation, data dissemination, and corporate insolvency procedures.

Bank Regulation. For several decades the Bank for International Settlements has provided a venue for national bank supervisors and regulators to pool their expertise and identify international standards for bank regulation. Since 1975, prompted by the failure of the Herstatt Bank, the Basle Committee on Banking Supervision consisting of representatives from the bank supervisory authorities of the major industrial countries has met three or four times a year and convened a number of technical subgroups. The Basle Committee periodically consults with and attempts to gain the support of other supervisory groups such as IOSCO.

The high-water mark in the Basle process was the 1988 Capital Accord. Signatories

agreed to hold their banks to minimal capital requirements of 8 per cent of risk-weighted assets.⁸ This was followed by the 1995 Market Risk Amendment, under which banks were permitted to use their proprietary models to calculate correlations among and within broad risk categories (such as interest rate risk, exchange rate risk, and equity price risk) in order to come up with more economically-sophisticated risk weights, and the 1997 Core Principles for surveillance of banking and financial systems, which identified five categories of standards for sound supervision and regulation.⁹ The Core Principles have been embraced by the IMF, which is helping to disseminate them to its member countries.¹⁰

The Capital Accord and the Core Principles demonstrate the feasibility of standard setting in the financial realm. Few would question that they are significant steps toward upgrading the supervision and regulation of banking systems. At the same time, this example is revealing of the limitations of the approach. The Committee on Banking Supervision makes decisions by

⁸Assets are divided into four or more risk categories (e.g. commercial loans, mortgage loan, interbank debt, and government debt), and a risk weighting is established for each.

⁹Significantly, the Core Principles were negotiated by the Basle Committee in cooperation with representatives from emerging-market countries. They were endorsed by G-10 central bank governors in April 1997 and by G-7 finance ministers in June. The 25 basic principles fall under five headings: preconditions for effective banking supervision (such as granting supervisors political independence and legal protection), licensing and structure (giving supervisors the authority to see that applicants for bank licenses have a proper operating plan, internal controls, and capital base), methods of ongoing bank supervision (including on-site and off-site inspections), information requirements (giving supervisors responsibility for seeing that each bank maintains adequate records and uses consistent accounting policies), and cross-border banking (that supervisors practice global consolidated supervision of home-country institutions and exchange information with other national supervisory authorities). See Bank for International Settlements (1997). I return to these points in Chapter 4.

¹⁰See Folkerts-Landau and Lindgren (1998).

consensus and has no enforcement power. The standards to which its members agree are implemented by national governments through their adoption of statutes and regulations. The Basle Capital Standards are merely recommendations; nothing requires countries to accept them. They are relatively undemanding minima; countries attaching a higher value to domestic financial stability have seen fit to opt for significantly more demanding standards.

Moreover, agreement has been difficult to achieve, even among the relatively homogenous OECD countries. More than a decade of hard slogging has been needed to get to this point. This is indicative of the difficulty of negotiating international standards in all the relevant areas.

Securities Market Regulation. A second example of standards-related work already underway is in the area of securities market regulation. The most important organization in this area is the International Organization of Securities Commissions (IOSCO), a forum for cooperation among national securities regulators headquartered in Montreal. Its regular membership consists of government regulators of securities and futures markets like the U.S. Securities and Exchange Commission (those of 134 member agencies from 81 countries at last count).¹¹ Essentially all countries with stock exchanges are represented, giving IOSCO a more broadly based membership than the Basle Committee. IOSCO consults extensively with international organizations, including the IMF.

IOSCO initially concentrated on coordinating efforts to curb and punish securities fraud.

¹¹And not self-regulating organizations like the Board of the New York Stock Exchange or the National Association of Securities Dealers. However, the self-regulating organizations are represented on a consultative committee.

It encouraged its member commissions to adopt bilateral and multilateral agreements to initiate proceedings against those suspected of committing such fraud in jurisdictions other than their own. Following the failure of Barings Plc, it turned to a wider range of regulatory and supervisory issues with implications for systemic risk.¹² Its Technical Committee has made recommendations regarding trigger levels for identifying large exposures on futures exchanges, for developing information sharing agreements among regulators, for developing standards for transparency in the case of default procedures, for the disclosure of customer positions, and for best practice in the treatment of positions, funds, and assets in the event of default. Its working group on multinational disclosure and accounting has identified a set of accounting issues that should be included in a core international accounting standard to be recognized by members. In 1995 it reached an agreement with the International Accounting Standards Committee on a schedule for establishing an international accounting standard to be used for quotations on all stock exchanges. In 1997 it circulated for consultation a draft setting out core principles for securities regulation. In 1998 it issued for public comment a set of international disclosure standards for cross-border offerings and initial listings by foreign issuers. It is working with the Basle Committee and the IASC to develop standards for the consolidated supervision of industrial groups and conglomerates.

IOSCO illustrates the feasibility of extending standards-related work to financial issues relevant to emerging economies. Its broad membership, including emerging as well as

¹²Its work program is expressly designed "to develop high-quality *standards* and promote market integrity through a process of member consensus and cooperation." Folkerts-Landau and Lindgren (1998), p.72, emphasis added.

advanced-industrial countries, positions it to address issues relevant to the supervision and regulation of securities markets in developing countries. It operates an Emerging Markets Committee which "endeavours to promote the development and improvement of emerging securities markets by establishing principles and minimum *standards*...."¹³ Much of the discussion at its annual meetings is concerned with issues related to securities regulation in emerging markets.

That said, international agreement on accounting standards has been elusive. Research and development, discontinued business, lease contracts, and retirement provisions have been especially problematic. In addition, it is important to bear in mind that IOSCO recommendations are advisory and nonbinding on members. The organization has no enforcement powers.

Data Dissemination. Another precedent is the IMF's own initiatives on the data dissemination front. Its General Data Dissemination System (GDDS) and the Special Data Dissemination Standard (SDDS) are clear international standards (a fact evident in the latter's name). The SDDS, targeted at countries possessing or seeking access to international capital markets, is intended to provide them a standard for the provision of economic and financial data to the public.¹⁴ Countries subscribe voluntarily but in doing so commit to providing specified information to the IMF about their practices in disseminating economic and financial data and to

¹³As described on the IOSCO web site (<http://www2.iosco.org>), emphasis added.

¹⁴Whereas the SDSS focuses on data dissemination by countries that generally already meet high quality data standards, the GDDS concentrates on improvement in data quality generally, including in those countries that have not secured access to international capital markets.

publishing 17 categories of data.¹⁵ They agree to take specific steps to improve access to data, data integrity, and data quality and to emphasize transparency in the compilation and dissemination of statistics. They are encouraged to announce publication calendars in advance, to release data simultaneously to all interested parties, and to describe the terms and conditions under which official statistics are produced. They are urged to provide documentation on statistical methodology and frameworks to assist users in assessing data quality. The IMF operates an electronic bulletin board where information on countries' subscription status can be found, with hyperlinks to national sources of the data themselves.

One can distinguish several rationales for this initiative. First, better information strengthens the ability of regulators and other national officials to recognize problems in their banking and financial systems, enabling them to take prompt corrective action. In the same way, countries' compliance with these provisions can aid the IMF's surveillance activities. Second, subscription status provides an objective indicator of country credit worthiness, providing an alternative to the judgements of commercial credit agencies. Investors might become reluctant to lend to countries that fail to subscribe to the standard or might use interest-rate spreads to ration credit to them. The hope is that better information will enable capital markets to draw back more smoothly, curtailing their lending more gradually in advance of the build-up of unsustainable pressures. Third, to the extent that bank runs, financial panics and international contagion are

¹⁵Subscription was opened in April 1996 by a letter from the IMF's Managing Director to all IMF Members and Governors. As of September 1998, 46 members subscribed to the SDSS. There is a transitional period through the end of 1998, after which subscribers have committed to be in full observance of the standard. Information about the SDSS bulletin board is available at <http://dsbb.imf.org>.

driven by the inability of market participants to distinguish between good and bad credit risks, the provision of better information by governments and other financial market participants may help to moderate herd behavior and violent market reactions.¹⁶

The SDSS, as currently constituted, is far from a complete solution to data-related problems. At present, the IMF bulletin board provides only "metadata" — that is, descriptions of how various statistics are compiled and a roadmap of where they are found. It does not vouch for or assess the accuracy of countries' economic and financial statistics or even of the metadata, much less analyze the implications of data quality for country risk.

Corporate Bankruptcy Reform. Many emerging markets lack modern bankruptcy codes. Where the bankruptcy code is opaque or enforcement is arbitrary, creditors may be reluctant to lend for fear of being unable to collect in adverse states of the world. Moreover, the lack of an efficient bankruptcy procedure can compound the effects of other problems. When business conditions deteriorate, creditors anticipating that the firms to which they have lent will experience financial distress and lacking confidence that they will be treated fairly will scramble to liquidate their claims. Thus, the effects of the initial shock can be aggravated by the desire of investors to scramble for the exits. And if borrowers default, the inability of lenders to repossess collateral may produce a cascade effect where the debtor's nonperformance forces its creditors into default. When the creditors include banks, the worse case scenario is a financial panic.

Many Asian countries entered their recent crises with archaic bankruptcy codes. Some of these made provision for the liquidation of insolvent enterprises but not for their reorganization

¹⁶Chapter 5 critiques these justifications, emphasizing their limitations.

and continued operation. Some made no provision for "debtor-in-possession financing" -- for giving seniority to creditors injecting new money.¹⁷ Their judiciaries were anything but independent and lacked the capacity to move quickly, frustrating creditors' attempts to take legal recourse. This uncertainty about how the legal process would play itself out removed the incentive for the parties to negotiate a voluntary workout in the shadow of the court.

Repairing this situation is conceptually straightforward. Archaic bankruptcy procedures should be updated. The development of a model bankruptcy code by the International Bar Association and international standards for insolvency and reorganization procedures can give governments the guidance they require. The key steps are strengthening the independence, integrity, and capacity of the judiciary, giving it the power to impose its decisions, and specifying firm deadlines for rendering judgements. While honesty requires admitting that this is easier said than done, Thailand and Indonesia have made progress in the requisite direction even

¹⁷Thailand in 1997 is illustrative. When its crisis erupted, Thailand had an archaic bankruptcy law whose sole purpose was to provide an orderly way of winding down the affairs of insolvent companies; it made no provision for corporate restructurings. It relied on the appointment of a receiver whose powers were limited to preparing a schedule of how the proceeds from liquidation would be distributed among the creditors. It barred creditors who advanced funds with knowledge of the debtor's insolvency from filing claims in bankruptcy proceedings, effectively precluding the provision of debtor-in-possession financing. Information provided to auditors and creditors was incomplete. The courts were lenient in granting adjournments and postponements; most liquidation proceedings took years. Where debt adjustments and restructurings did take place, they proceeded as out-of-court workouts negotiated by the company and its creditors, typically Thai and international commercial banks. Workouts became more difficult when there were a large number of bondholders involved and when bank workout groups were overstretched, as in 1997. By the end of the year, "loan workouts in Thailand [had become]...characterized by a highly disorderly process..." in the words of one set of experts (Darrow, Chandler and Campbell 1997, p.9). One could tell similar tales about other countries.

under considerable duress.¹⁸

For countries experiencing a full-blown economic and financial crisis, bankruptcy reform will have to extend beyond this. When a large number of private borrowers find themselves simultaneously unable to service their debts because of the collapse of the exchange rate, it may in addition be necessary to appoint an ombudsman or "workout czar" to coordinate their interlocking negotiations. This individual, supported by a small cadre of accountants, lawyers and economists, would organize meetings of borrowers and lenders, encourage the provision of accurate information on the debtor's financial condition, and act as an honest broker. This approach was tried with some success by the Mexican government following the Tequila crisis when it established a Restructuring Commission (UCABE) to consult behind the scenes with key constituencies and coordinate negotiations. The Thai variant has been for the government to issue a non-binding 19-point plan to be used as the framework for all corporate workouts involving multiple creditors, backed up by the threat that the government would step in and enforce its timetable for implementing those guidelines if creditors and debtors made insufficient

¹⁸Indonesia implemented amendments to its bankruptcy law at the end of August 1998 to introduce a tight deadline of 30 days for court decisions, set up a new commercial court with specially-trained judges, and provide for a 270-day suspension of payments as an alternative to liquidation. It introduced independent receivers for liquidation and administrators for the 270-day stay as alternatives to the state receiver agency. This did not eliminate all concerns: there remain fears that some debtors will use the 270-day stay as an opportunity to strip assets rather than to restructure before entering liquidation, and that a shortage of trained accountants and lawyers will undermine the operation of the receivership and administration system. In addition, the government announced in September that small creditors would be barred from pushing for liquidation, and the first case filed under the new bankruptcy law was dismissed on the grounds that a similar case was already pending against an affiliate.

progress.¹⁹

Collapse of the exchange rate can further complicate restructurings by creating uncertainty about the future price of foreign exchange and hence about the fundamental value of firms. A temporarily low exchange rate may leave creditors reluctant to settle because they hold out hope that the exchange rate will recover subsequently, enhancing the value of their claims. But the exchange rate is unlikely to recover so long as creditors hesitate to settle and the country's international financial relations are not normalized. To help debtors and creditors break out of this trap, governments have assumed the exchange risk. The Mexican FICORCA and Indonesian INDRA programs provide companies restructuring their debts a limited exchange rate guarantee, with the goal eliminating some of the risks and costs that would otherwise stand in the way of the successful conclusion of negotiations. Unfortunately, such programs are not always effective, due to design flaws. The design of such arrangements is not something that the International Bar Association has addressed. The international policy community needs to press it or, more likely, another standards-related body to take on this task.

Finally, there is the need to harmonize bankruptcy procedures across countries. Even the most basic feature of a national bankruptcy procedure, the stay on payments, can be vitiated when the debtor has assets in more than one country and the conditions under which a stay can be imposed differ across them. Not much progress has been made in the last three decades despite a series of international conferences and draft conventions. But as the integration of

¹⁹The 19-point plan specified that debt restructuring should involve corporate reorganization as well as new repayment terms, agreement by creditors to a debt standstill, and a pledge by creditors to provide timely and accurate financial information. See Bardacke (1998).

capital markets proceeds, it becomes more urgent for policy makers to redouble their efforts on this front.

Problems

In several important areas, there does not exist a consensus on what an international standard should entail. Insolvency procedures differ across OECD countries, for example, in the rights they assign creditors and the powers they allot the courts. Even within the European Union, a relatively homogeneous group of nations, efforts to harmonize insolvency laws have come to naught. After many years of preparatory negotiations, a limited convention on insolvency procedures, concerned mainly to establish common rules of law to adjudicate difficult creditor relationships, was issued in 1995 but has not been ratified, owing mainly to opposition by the UK.²⁰ The contentious debate in the Congress on reform of the U.S. bankruptcy code is indicative that there is not even agreement on these issues within individual societies. Nor are disagreements limited to economists; they also infect other disciplines, notably the law. Corporate governance, to take the obvious example, entails questions of contract enforcement, shareholders' rights, private property rights, and mechanisms for the fair resolution of conflicts among stakeholders, all of which raise sticky legal issues. Little agreement exists on internationally-accepted standards for these areas because countries have very different legal traditions and systems (e.g. common law, civil law, religious law, tribal law, and community law). It is optimistic to think that the elements of all of these traditions can be brought under a

²⁰For the background, see Fletcher (1997).

single international standard.²¹

These are difficult problems. But given that countries coming from all these different traditions will be increasingly active participants on international capital markets, there is no alternative to attempting to define international standards that are general enough to accommodate their different legal traditions but at the same time rigorous enough to provide the effective corporate governance and market discipline required for efficient market outcomes.

Enforcement. In some cases, the threat to financial stability arises not from the letter of the law but from how the law is (or is not) enforced. The problem with Indonesia's bankruptcy law, with Indonesia and Korea's regulations on connected lending, and with Malaysia and Indonesia's accounting standards was not so much that they were poorly designed (although this can be argued as well in some cases) as that they were badly or arbitrarily enforced. Failure to implement or enforce laws can occur for a number of reasons: conflicts of interest, political pressures, corruption, limited administrative capacity, and the absence of an independent judiciary.²² However much national governments and the international community strive to bring domestic laws into conformance with international standards, their efforts will be of little

²¹ Indeed, the efforts of the International Corporate Governance Network to agree on a statement of global corporate governance principles at its third plenary meeting in 1998 revealed deep disagreements among delegates over even the most basic questions. See Taylor (1998).

²² The problem of limited administrative capacity is illustrated by Korean bankruptcy procedures, lack of judicial independence by their Indonesian counterparts. In Korea, the Seoul district court had only four bankruptcy judges at the beginning of 1998 to handle cases numbering in the hundreds. In Indonesia, "People wish to avoid courts because they are considered expensive, notoriously unpredictable and unreliable. In addition there is a pervasive culture of corruption at all levels. High profile persons are perceived as exempt from the process. The government may also step in at any point to rearrange the process to suit what it considers its interest." Gamble (1998), p.3.

consequence if enforcement is not fair and vigorous.

This problem has been a sticking point in international efforts to strengthen bank supervision and regulation, the area where international standards are most advanced. The Basle Committee's early efforts to strengthen the supervision and regulation of cross-border banking (starting with the Basle Concordat in 1975) focused on the letter of the law. More recently, the IMF, building on the Basle Core Principles, has emphasized the need to establish a legal and political setting in which the relevant regulations will be enforced.²³ It has stressed the need to vest responsibility for the function in an independent agency, to ensure that the supervisory authority receives adequate operating income from a source other than the regular budget, and to appoint the head of the supervisory authority to a fixed term in office so that he is protected from the threat of termination. It has recommended that supervisory authorities should not be held personally liable for damages caused by any actions legitimately performed in the course of their duties and that they be required to publish periodic reports so that the basis for decisions can be assessed and conflicts of interest can be ferreted out. It has already taken steps, in other words, toward helping to establish international standards not just for what kinds of bank regulations should be adopted but also for what kind of institutional arrangements should be put in place to ensure that they are enforced.

Thus, the fact that the enforcement of statutes is problematic only reinforces the argument for standards in whose context those enforcement problems can be addressed.

²³See Folkerts-Landau and Lindgren (1998), chapter VII.

Defining a Role for the International Financial Institutions

Promoting the development of international financial standards and encouraging their implementation at the national level will require a clearer division of labor and more systematic collaboration among international organizations than has occurred heretofore. Traditionally, the IMF has taken the lead in work on data-dissemination standards, fiscal transparency and monetary practice, while the World Bank has been responsible for advice on bank supervision, securities-market regulation, corporate governance and bankruptcy procedures. With the IMF tying its financial assistance to progress in these additional areas, especially in Asia, the division of labor has been blurred. And then there is the fact that banking supervision has long been a concern of the BIS. Rivalry among IFI's is not entirely bad; healthy competition between the BIS and the Fund did stimulate the development of the Core Principles. But collaboration is also necessary — actual collaboration and not just lip service to the ideal.

The most difficult problem is deciding how active the IMF and other international financial institutions should be in the design and implementation of standards. The most conservative approach would be for the Fund and other multilaterals to simply observe the activities of existing private-sector self-regulating organizations and to participate as an observer or ex officio member in their meetings, as the IMF does with IOSCO. The advantage of active participation is that the international financial institutions, having contributed to the negotiation process on behalf of their members, would then be in a relatively strong position to urge compliance on member countries.

In addition, the IMF should use those standards in its own surveillance. It should monitor countries' compliance in conjunction with its regular Article IV surveillance, providing the

Executive Board an opportunity to comment on members' arrangements, which would apply pressure for corrective action where national practice falls short. To fend off complaints of IMF mission creep, it should start with standards closest to its traditional area of responsibility; having already started with standards for data dissemination and fiscal transparency, the Fund would logically proceed to securities market regulation and bank supervision.

More ambitious still would be for the IMF to condition its financial assistance on implementation of international standards. Countries that borrow from the Fund and whose national practices were judged deficient could be required to take specific steps to bring domestic arrangements into line with international standards as a condition for the disbursement of funds. The IMF already has conditioned its assistance on governments agreeing to close problem banks, for example; from there it is a small step to ask them to reform the ways in which they supervise and regulate the banking system. And the Fund has already made agreement to reform national bankruptcy procedures a precondition for the disbursement of funds to Indonesia and South Korea. Extending and generalizing these practices would require IMF staff to develop expertise in areas like corporate governance and bankruptcy law that have not been their traditional areas of competence. The advantage of relying on private-sector bodies to identify those standards is precisely that the latter provide a manual or guidebook of measures to which policymakers and IMF staff can refer.

Most ambitious of all would be for the Fund to inform the markets of its assessment of members' compliance with international financial standards. The IMF currently publishes analogous information in areas where its Articles of Agreement give it a mandate. It publishes information on whether each member complies with Article VIII of the IMF Articles of

Agreement requiring it to make its currency convertible for purposes of current account transactions. It publishes a table of "bullet points" indicating the presence or absence of various categories of exchange and capital controls in its *Annual Report on Exchange Controls and Exchange Restrictions*. In theory, there is no reason why it could not do the same for the International Accounting Standards Committee's 33 accounting standards, IOSCO's ten principles for use by securities and futures regulatory authorities, or the International Bar Association's guidelines for a model bankruptcy law. It could thus issue an annual report on financial standards where it rated countries' compliance in each of these areas.

In some cases, the rating exercise would relatively straightforward; in auditing, for example, the question would simply be whether banks and companies hired reputable international accounting firms to examine their books. In other cases, however, evaluating countries' compliance with financial standards will involve a considerable element of judgement, exposing the Fund to complaints of political bias. This difficulty is heightened by the fact that the Fund possesses no explicit mandate for work in this area. And it may find it hard to blow the whistle on countries that fail to comply for fear of compounding their financial difficulties.

These are arguments for encouraging the relevant self-organizing private-sector committees to carry out the compliance exercise themselves. Each committee might be encouraged to establish an electronic bulletin board where such information could be centralized. Hyperlinks could be provided to the Fund's own electronic bulletin board, much as they already are for financial market data. Where the self-organizing committee is comprised of national regulators, the rating function could be privatized; it could be spun off to commercial auditing and accounting firms or commercial concerns like Fitch-IBCA with expertise in the relevant

areas. Their assessments would be subject to the same kind of criticism presently levied at commercial credit-rating agencies, namely, that changes in their evaluations tended to lag changes in actual market conditions. But that would be for the markets to judge. The U.S. Commerce Department was successfully spun off the Index of Leading Indicators to the Conference Board. There is no reason why the Fund should not start with a similar strategy with respect to rating countries' compliance with standards and see whether it works. In addition, in those narrow areas where the Fund has special competence (data dissemination, financial regulation, other forms of transparency), it should follow the recommendation of the Group of Twenty Two (1998) and publicly issue a "Transparency Report" for each country at the conclusion of its Article IV surveillance exercise.

Implications

Promoting the development of and compliance with international standards for financial regulation, auditing and accounting, corporate governance and insolvency law might be seen as a radical departure for international financial institutions like the IMF. In reality, the official community has already moved significantly in this direction, notably in the activities of the Basle Committee on Banking Supervision but also in the efforts of the OECD to negotiate principles for corporate governance and of the UN to sketch a model bankruptcy code. The IMF is involved, having established a data dissemination standard for countries intending to access international capital markets and a code of fiscal transparency. That governments and international organizations are being pushed into involvement in this area over their own protests is evidence that financial regulation, auditing and accounting, corporate governance and

insolvency law are too important to financial stability to ignore. It is evidence that negotiation and compliance with international standards are the only practical way of addressing these problems.

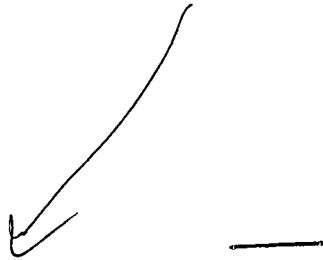
Differences in economic, social and legal traditions across countries complicate the process of reaching agreement on standards. And ensuring effective enforcement of the laws or regulations through which a standard is implemented at the national level is more difficult than reaching agreement on the letter of that law. Solutions to these problems will not be reached quickly.

The international financial institutions, for their part, have yet to establish an efficient division of labor and to settle on a set of working relationship with the relevant private-sector organizations. Should they simply encourage the negotiation of the relevant standards or actively involve themselves in that process? Should they simply urge their member countries to recognize and comply with those standards, or monitor compliance, make compliance a condition for financial assistance, and even release their assessments of compliance to the markets?

These questions will take time to answer. But the answers will emerge in the course of the standard-setting process itself, which is an argument for getting started.

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DANI RODRIK, OFC —



MAKING OPENNESS WORK:
THE NEW GLOBAL ECONOMY AND THE DEVELOPING COUNTRIES

Dani Rodrik
Harvard University

John F. Kennedy School of Government
79 Kennedy Street
Cambridge, MA 02138
(617) 495-9454
Fax: (617) 496-5747
E-mail: dani_rodrik@harvard.edu
<http://www.ksg.harvard.edu/rodrik>

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Chapter 1: Introduction

A day in the life of a finance minister

The minister begins his day by logging on to his computer to find out how currency and equity markets have been doing in the United States, Europe, and East Asia. He searches the internet for press reports and leafs through the international financial press on his desk. The international markets are calm and his search turns up no unpleasant news items on the country's economy. Relieved, he postpones the decision he had made the night before to raise interest rates.

An assistant has circled a brief item in the *Financial Times* on U.S. plans to take a neighboring country to the WTO on the grounds that its regional-assistance programs violate trade rules. The minister makes a mental note to check with the minister of trade and industry to see whether their own regional policies can be challenged in the WTO as well.

The first meeting of the day is a staff briefing on the upcoming consultation with the IMF. The IMF has been complaining that the country's fiscal deficit remains too high and that its social security system is in need of an overhaul. The minister tells his staff to prepare a new set of budget projections based on lower public-sector wage increases for the coming year.

A delegation from an international credit-rating agency is ushered in next. The minister gives his standard speech. The economy has been transformed radically in the last few years and is poised for take-off. Exports are up 15 percent, the main state-owned petroleum firm is about to be privatized, and the fallout in the stock market from the Asian crisis has been contained so far. The government remains more committed than ever to responsible financial and fiscal policies. One of the members of the delegation, introduced as the new desk economist for the country, is furiously taking notes. The minister notices that he does not look any older than his

own son, who has just graduated from college and whom he considers barely responsible enough to be entrusted with the family car.

At lunch, the minister is a keynote speaker at a conference put together by a major international consulting firm on "The Imperatives of Globalization." "We are all globalizers now," he concludes to applause. "No nation can afford to stay outside the mainstream of the global economy. We must make our economies internationally competitive by opening up, liberalizing, and privatizing. Only then can we generate employment and growth opportunities for our economies."

In the afternoon, the minister meets first with a group of businessmen representing the economy's largest exporting firms. The delegation complains about the level of the exchange rate. They are worried that the government's high interest-rate policy is keeping the domestic currency too strong, and that their products are being priced out of competition in world markets. The minister promises to expand the range of tax credits for which exporters can qualify.

Next in line is the chief executive of a prominent international energy firm, accompanied by a former U.S. secretary of defense. The executive reiterates his company's strong interest in the forthcoming privatization of the national oil company. The former secretary underlines the importance of the country to the United States and emphasizes that the auctioning of the oil company will be watched closely as a signal of the country's determination to join "the civilized world of free-market economies." The minister reminds himself to read a report recently prepared by the anti-trust commission on the consequences of the monopolization of the energy sector.

After another check of international financial markets and a quick update of the news on CNN, the minister is ready to go home. As he is leaving, he becomes vaguely aware of the loud

din outside the ministry building. His aide apologizes, saying that it has proved difficult to keep away the public employees who have been demonstrating for days for their back pay. The minister sighs. He hopes he can make it back in time for his favorite TV show, the X-Files.

The new global environment for development

Prior to the recent blowup in global financial markets, this could have been a typical day in the life of a finance minister in Brazil, Russia, Turkey, or in any of the scores of developing countries that were fast becoming integrated with the world economy. In all of these countries, the context in which governments are thinking about policies for economic development, and the terms around which such policies are discussed, have changed radically. The world economy and the “dictates” of international economic integration loom much larger than ever before. Policy makers have become all too aware of the increasing attention that their economies’ relations with foreign markets demand. As Table 1.1 shows, the volume of international trade has increased at twice the rate of growth of world output over the last decade. Gross capital flows have expanded even more dramatically, expanding at double-digit rates annually.

International economic integration is driven partly by technological changes that have reduced transport and communications costs. But the progressive removal of restrictions on trade in goods, services, and capital has also played an important role. In this new environment, external constraints on the exercise of fiscal, monetary, trade, and industrial policies have become considerably tighter. International capital markets are quick to punish countries that pursue policies that are perceived to be incompatible with macroeconomic sustainability. The ubiquitous role of the World Bank and the IMF make it harder for governments dependent on these institutions to embark on economic strategies that depart from orthodoxy. The new

Table 1.1

The growth of international economic activity, 1964-1994 (annual averages, in percent)

	export volume	world FDI flows	international bank loans	world real GDP
1964-1973	9.2	—	34.0	4.6
1973-1980	4.6	14.8	26.7	3.6
1980-1985	2.4	4.9	12.0	2.6
1985-1994	6.7	14.3	12.0	3.2

Source: Rowthorn and Kozul-Wright (1998) from original IMF and BIS sources.

disciplines negotiated during the Uruguay Round of trade negotiations impose additional restrictions on trade and industrial policies, as in the case of domestic-content requirements or patent laws. In addition, many developing countries are under pressure from non-governmental groups in the North to raise labor and environmental standards.

Partly as a consequence of conditionality imposed by the Bretton Woods institutions, but also because of widespread domestic dissatisfaction with the previous set of policies, outward orientation has become the norm rather than the exception among developing nations. In fact, a remarkable convergence of views among academics and policy makers has developed on the virtues of what is variably called the Washington consensus, the market-oriented model, or the neo-liberal approach.¹ Various advocates of de-linkage from the world economy—nationalists, socialists, and “dependency” theorists—have now turned into ardent boosters of openness, a transformation that is perhaps nowhere more striking than in the person of Brazil’s president, Fernando Henrique Cardoso, a former leading theorist of the “dependency” school.² As an Argentinean official puts it, “the old theme of the invading Yankee has given way to the wonderful Yankee driving the global train that you’d better board immediately or you’re finished!” (quoted in Cohen 1998).

Tables 1.2 and 1.3 summarize the trends in tariff and non-tariff barriers. As the tables show, Latin American countries in particular have drastically reduced their levels of trade protection since the early 1980s. Their average tariff and non-tariff barriers are, with few

¹ The term “Washington consensus” was coined by John Williamson. For a useful collection of dissenting views on the new consensus, see the volume by Baker, Epstein, and Pollin (1998 forthcoming).

² “Leaping into the global economy is the only option,” Cardoso is quoted as saying in the Wall Street Journal (December 15, 1995, p. A1). “If we don’t do this, we don’t have a way of competing.... It’s not an imposition from outside. It’s a necessity that we have.” As the New York Times (November 20, 1994) put it on the occasion of Cardoso’s election to the Presidency, “if [he] had run for office in the United States, his opponent would have had a field day dredging up his past.” (I am grateful to Avinash Dixit for the reference to the NYT article.)

Table 1.2

Weighted average tariffs by region and sector (percent)

Product Category	Primary products	Food	Agricultural raw materials	Crude fertilizers & mineral ores	Mineral fuels	Non-ferrous metals	Manufactured Products	Chemicals	Iron & Steel	Machinery & Equipment	Other Manufactured Products	All Product Categories
LATIN AMERICA & THE CARIBBEAN												
80-83 (4 country avg.)	16.8	22.3	20.4	14.1	10.3	16.3	23.6	20.1	18.2	23.2	29.1	21.3
84-87 (11 country avg.)	21.1	25.6	21.8	13.9	14.8	20.4	25.1	19.8	20.3	24.2	31.5	23.9
88-90 (8 country avg.)	17.3	24.5	17.1	11.4	11.1	14.6	22.7	17.3	17.0	21.8	29.0	20.9
91-93 (9 country avg)	9.8	12.8	9.5	5.5	7.4	8.3	12.5	9.3	10.1	12.6	15.0	11.6
EAST ASIA												
80-83 (5 country avg)	10.5	21.9	9.8	6.3	2.1	10.2	21.6	15.0	12.4	19.8	31.8	18.2
84-87 (7country avg.)	10.0	16.3	8.8	4.9	3.6	10.1	18.1	13.0	10.1	18.2	23.0	15.8
88-90 (7 country avg.)	11.1	17.6	8.9	4.8	7.0	9.9	18.0	12.8	9.0	18.0	23.3	15.7
91-93 (7 country avg.)	9.9	16.0	8.3	4.2	6.9	9.3	17.1	12.2	9.3	17.3	21.0	14.7
SUB-SAHARAN AFRICA												
80-83 (13 country avg.)	24.4	33.8	24.4	17.9	14.3	21.5	32.8	23.5	19.6	31.8	43.6	30.2
84-87 (13 country avg.)	20.1	25.4	20.0	14.7	13.7	18.5	23.5	17.7	19.0	22.7	30.1	22.6
88-90 (10 country avg.)	18.9	30.6	15.4	10.1	8.1	14.5	22.5	14.8	14.8	20.1	33.3	21.3

Source: UNCTAD (1994).

Table 1.3

Weighted average incidence of non-tariff measures by region and sector (percent)

Product Category	Primary Products	Food	Agricultural raw materials	Crude fertilizers & mineral ores	Mineral fuels	Non-ferrous metals	Manufactured Products	Chemicals	Iron & Steel	Machinery & Equipment	Other Manufactured Products	All Product Categories
LATIN AMERICA & THE CARIBBEAN												
84-87 (11 country avg.)	42.8	45.1	19.9	12.4	51.6	23.6	28.4	18.4	31.5	25.6	39.0	32.9
88-90 (8 country avg.)	48.6	51.1	21.9	13.2	57.9	10.0	20.9	17.4	26.3	19.3	24.8	30.3
91-93 (7 country avg.)	16.1	12.6	3.6	0.1	24.1	0.1	1.8	1.3	3.3	2.4	0.5	6.6
EAST ASIA												
84-87 (7 country avg.)	31.1	36.1	24.3	19.8	30.0	14.6	23.1	30.3	17.7	24.3	18.0	25.6
88-90 (7 country avg.)	18.8	19.5	11.4	5.3	22.1	1.4	8.3	7.1	20.0	7.8	6.7	11.8
91-93 (7 country avg.)	11.2	12.6	8.6	4.6	11.8	1.0	5.5	1.7	16.5	6.0	3.6	7.4
SUB-SAHARAN AFRICA												
84-87 (13 country avg.)	48.4	61.7	43.0	32.6	45.5	39.3	42.7	28.7	48.3	41.1	52.4	45.5
88-90 (10-country avg.)	47.4	58.6	45.9	38.0	39.1	46.7	45.4	40.5	47.3	43.5	51.4	46.1

Source: UNCTAD (1994).

exceptions, lower now than those that prevail in East Asia. Non-tariff barriers have been reduced significantly in East Asia as well. However, Sub-Saharan Africa lags behind these two regions, especially with regard to the liberalization of non-tariff barriers.³ Combine these developments with the dramatic opening of most of the former socialist countries of Eastern Europe and the post-Soviet states, and we have the widest ranging trade liberalization that the world has ever witnessed.

Many developing nations are benefiting handsomely from an increasingly integrated world economy. According to the World Trade Organization (WTO), eleven developing countries were among the world's top 30 exporters in 1997 (Hong Kong, China, South Korea, Singapore, Taiwan, Mexico, Malaysia, Thailand, Saudi Arabia, Indonesia, and Brazil). If the European Union is treated as a single entity, eight more developing countries make the list (India, South Africa, United Arab Emirates, Turkey, Argentina, Philippines, Venezuela, and Israel). According to the OECD (1997), there are seven developing countries among the world's top 20 recipients of direct foreign investment (China, Mexico, Malaysia, Singapore, Argentina, Brazil, and Indonesia). Many other developing countries, however, are falling behind; particularly Sub-Saharan African countries, which have seen their share of world trade and investment flows shrink over the last three decades.

In the aftermath of the global economic turmoil of 1997-98, it is possible that many of these trends will be reversed. The financial panic that spread from Asia to Russia, and then on to Latin America has altered the perceptions of many policy makers on the benefits of participation in the global economy. As these words were being written in October 1998, Russia had

³ The data for Africa are, as usual, patchy and not terribly recent. It is commonly accepted, however, that Africa's trade policies remain more restrictive than those in the rest of the world, despite a trend toward reform since the 1980s.

defaulted on its obligations to foreign lenders. Malaysia had imposed strict capital and exchange controls, and even Hong Kong had undertaken some market-unfriendly measures in support of its currency. Normally restrained observers were suggesting that “global capitalism—whose triumph once seemed inevitable—is now in full retreat, perhaps for many years” (Samuelson 1998).

It is too early to judge how strong the backlash will be and how long it will last. Discontent so far has focused on the workings of the international financial system, and not on the trading regime per se. Russia aside, no government is seriously contemplating restrictions on international trade or on direct foreign investment. It is possible, and perhaps likely, that cooler heads will prevail and that a senseless over-reaction in the direction of protectionism and beggar-thy-neighbor policies will be avoided.

But preventing a backlash—today, or in the aftermath of the next crisis—also requires that we develop and promote a more nuanced, less ideological understanding of international economic integration. We need to be clearer about what the international economy can and cannot do for national economic development; about the complementary policies and institutions required at home to sustain international economic integration; and about the fundamental determinants of successful national economic performance more broadly, without which an open world economy is not worth a dime. In other words, we need to know how to make openness work.

Making openness work

As I will discuss in the next chapter, openness can be a source of many economic benefits. The importation of investment and intermediate goods that may not be available

domestically at comparable cost, the transfer of ideas and technology from more developed nations, and access to foreign savings can help poor nations circumvent some of the traditional obstacles to rapid growth.

The main theme of this book is that these are only potential benefits, to be realized in full only when the complementary policies and institutions are in place at home. Furthermore, the gains that derive from openness have to be viewed in their proper perspective. The claims made by the boosters of international economic integration, I will argue, are frequently inflated or downright false. Countries that have done well in the postwar period are those that have been able to formulate a domestic investment strategy to kick-start growth and those that have had the appropriate institutions to handle adverse external shocks, not those that have relied on reduced barriers to trade and capital flows. Policy makers therefore have to focus on the fundamentals of economic growth—investment, macroeconomic stability, human resources, and good governance—and not let international economic integration dominate their thinking on development.

Three propositions about openness constitute the starting point for this book's discussion of economic policy in countries that are in the process of integrating themselves into the world economy.

First, openness by itself will not generate economic growth. The fundamental determinants of economic growth are the accumulation of physical and human capital and technological development. Openness can contribute to these determinants in ways to be discussed more fully in the next chapter—by making cheap capital goods available for investment or by allowing the transmission of ideas from advanced countries, for example. But these potential linkages are contingent ones, requiring other pieces of the puzzle to fall into

place. As I will show, countries that grow fast typically also become more open; but the reverse relationship—from increased openness to faster growth—is much weaker.⁴

I emphasize that this is not an argument against openness. It is a warning that a strategy of economic development that relies exclusively on encouraging exports and DFI, without emphasizing the complementary policies and institutions to be discussed more extensively below, risks disappointment and failure.

Second, openness will likely exert pressures that widen income and wealth disparities within countries.⁵ The relationship between trade and wages has been discussed to date primarily in the context of the advanced industrial countries, with the literature trying to sort out the relative contributions of trade and technology to rising inequality. The evidence from the developing countries indicates that a similar rise in inequality has been experienced in many of the Latin American countries that have opened up their economies during the last two decades.⁶ A striking example is Chile, which presents one of the most dramatic and successful cases of opening up. During the period of liberalization, the Gini coefficient in Chile registered a twelve-

⁴ This statement may appear to contradict a voluminous empirical literature on trade policy and growth. However, this literature has a number of conceptual and empirical flaws that render their interpretation problematic. For example, the indicators of trade policy employed often conflate tariff and non-tariff barriers with macroeconomic imbalances (such as black market premia or real-exchange rate overvaluations). See Rodrik (1995b, section 4) for a discussion. Sachs and Warner (1995) have recently developed a measure of "openness" which is strongly correlated with growth and has received wide attention. This measure is a composite indicator that combines information on tariff and non-tariff barriers with three other sorts of evidence: black-market premia (an indicator of macroeconomic imbalance); a dummy for countries with export marketing boards (which is highly correlated with location in Sub-Saharan Africa); and a dummy for socialist countries (which is a broad indicator of political-regime type). Very little of the action in this indicator is in the trade policy variables proper (i.e., tariff and non-tariff barriers). Excluding the information on tariff and non-tariff barriers from the construction of the Sachs-Warner index yields regression results that are virtually identical to the original ones. On the other hand, a Sachs-Warner-like index that uses information only on tariff and non-tariff barriers does not enter the regression with a statistically significant coefficient. In other words, the strong empirical results that Sachs and Warner (1995) obtain derive from indicators other than traditional commercial policies.

⁵ The ways in which international economic integration exacerbates domestic cleavages along lines of skills, mobility, and values is discussed in Rodrik (1997c).

⁶ See Wood (1997) for a review of the evidence, and Feenstra and Hanson (1996), Pissarides (1997), and Wood (1997) for possible explanations.

point increase (from 0.46 in 1971 to 0.58 in 1989), one of the largest jumps ever witnessed in any country over such a short period of time.⁷ Of course, many other things happened in Chile during this period, including the repression of trade unions. But similar, if less marked increases in inequality have been observed since the late 1980s in other economies choosing to open up rapidly as well, particularly in Latin America and among the formerly socialist economies.⁸

Hence, contrary to expectations, trade and investment liberalization appears to have increased the demand for skills in the developing countries, instead of reducing it. The beneficiaries, therefore, happen to be the better paid, higher-skilled individuals. The reasons for this are not entirely clear. One possibility is that many of the activities that are complementary to exports and DFI—such as banking, finance, insurance, accounting and other services—are quite intensive in the use of skilled workers.

Third, openness will leave countries vulnerable to external shocks that can trigger domestic conflicts and political upheavals. These consequences are damaging not only in their own right, but also serve to prolong and magnify the effects of external shocks. The developing world has been buffeted by a series of external shocks since the 1970s, arising from rapid changes in the terms of trade, spikes in world interest rates, or sudden reversals in capital flows. The effect of the debt crisis of the 1980s in Latin America was a poignant demonstration of the consequences of the inability to handle external shocks. Shocks such as these will always be part of the global landscape. As the recent Asian financial crisis demonstrates, no country, no matter what its trade orientation or the quality of its economic policies, is entirely immune to them.

⁷ The figures are from the Deininger and Squire (1996) compendium of income distribution data. The two figures are not strictly comparable, however, as the first is based on household incomes and the second on personal incomes.

⁸ For the evidence, see Lora and Londono (1998, Figure 8) on Latin America and Kolodko (1998) on transition economies.

Therefore, the ability to manage turbulence in the world economy is a critical component of a strategy of making openness work.

Hence openness is a mixed blessing, one that will need to be nurtured in order to make it a positive force for economic development. In the rest of this book, I will discuss some of the complementary policies and institutions that are required. I will emphasize the need for two strategies in particular: (a) a domestic investment strategy; and (b) a strategy of strengthening domestic institutions of conflict management. I make a few introductory remarks about each here.

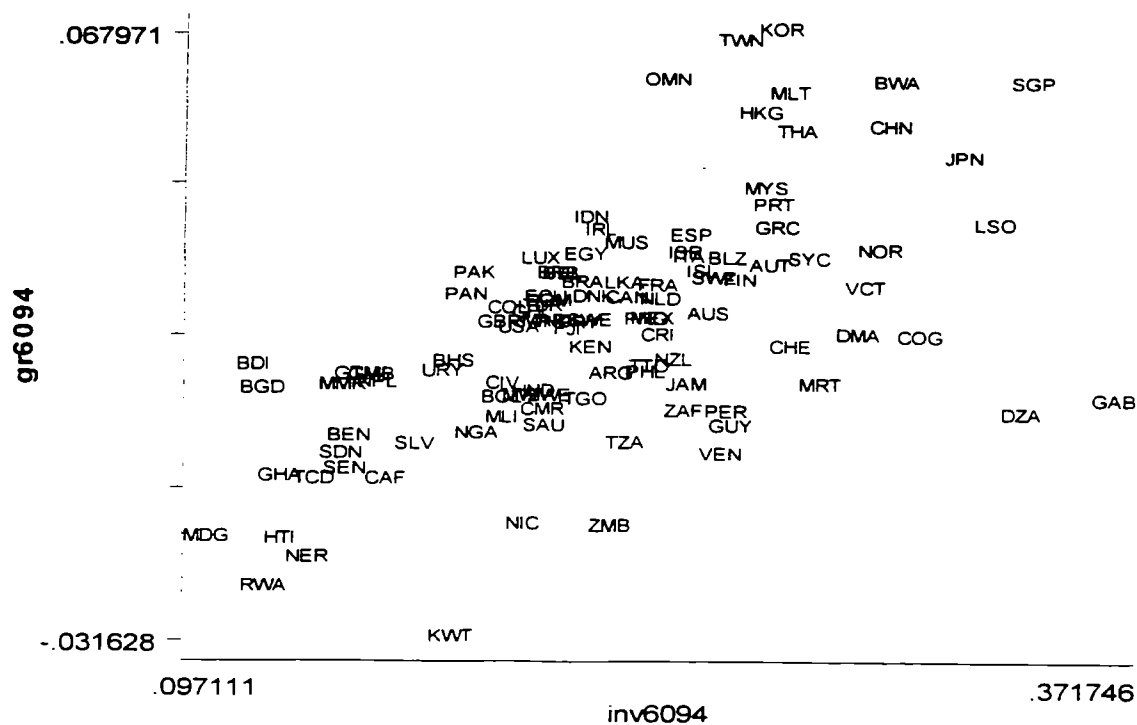
Importance of investment

The relationship between investment and growth tends to be erratic in the short-run. Changes in investment do not have strong, determinate effects on growth rates over horizons of a few years or so (Easterly 1997). But in the long run, investment is key. Cross-national studies have shown that investment is one of the few robust correlates of economic growth over longer horizons spanning decades (Levine and Renelt 1992). The close association across countries between investment rates and economic growth since 1960 is shown in Figure 1.1.

Recent studies that have scrutinized the sources of East Asian growth have highlighted the overwhelming importance of accumulation for the countries in that region. In particular, these studies have found that total factor productivity (TFP) growth played a minor role compared to physical investment in driving East Asian growth (Young 1995; Collins and Bosworth 1996). The proximate determinant of East Asia's performance has been its outstanding investment effort. South Korea, to take one of the most striking examples, was able

Figure 1

Relationship between investment and growth, 1960-94



Source: World Bank data.

Notes: inv6094 and gr6094 are the investment shares in GDP and growth rates over 1960-94, respectively.

to raise its investment rate from less than ten percent of GDP in 1960 to 30 percent by the late 1970s.

Where has this investment come from? While opening up to the world economy can sometimes stimulate investment, it is a mistake to believe that there is a determinate relationship between openness and investment incentives. Standard economic theory suggests that the relationship between trade liberalization and the return to capital is generally ambiguous. If anything, in countries which are poorly endowed with physical capital, opening up would be expected to reduce the return to capital through Stolper-Samuelson channels, dampening private investment incentives.⁹ As I will discuss in chapter 3, governments in East Asia complemented their outward-orientation with a coherent domestic investment strategy that raised the private return to capital and kindled the animal spirits of entrepreneurs (see also Akyuz and Gore 1994). The South Korean, Taiwanese, and Singaporean governments went considerably beyond simply removing obstacles to private investment: they heavily subsidized it.

What drives economic growth in practice is a process whereby capacity expansion and the profitability of private investment mutually feed on each other. There is no single way of raising the private return to capital to start this process off. Even among the three cases just cited, investment subsidies took different forms (see chapter 3). Governments have to be imaginative in devising investment strategies that exploit their country's resources and its capabilities, while respecting administrative and budgetary constraints. A useful starting point is to acknowledge that openness is part of a development strategy; it does not substitute for it.

⁹ According to the Stolper-Samuelson theorem, the removal of trade restrictions raises the real return to a country's relatively abundant factor of production, and reduces the real return to the scarce factor. Note that the distributional evidence from Latin America discussed earlier contradicts the expectations derived from the theorem. So the theorem should not be taken very seriously in the predictive sense.

Our case studies of East Asian countries, as well as the systematic evidence from episodes of investment transitions (in chapter 3), suggest that investment is causal where economic growth is concerned. An increase in investment, for whatever reason, tends to spur growth. However, we need not interpret the direction of causality too strictly. In practice, sustained periods of economic growth exhibit a symbiotic relationship between growth and investment, with each feeding on and in turn stimulating the other. As we shall see, such periods of take-off can be ignited either by measures that encourage investment directly, or by policies that create profitable production opportunities.

Importance of domestic institutions of conflict management

As Figure 1.1 shows, the relationship between investment rates and growth across countries is a strong one, but it is not perfect. Over shorter time horizons, the relationship tends to disappear altogether. Most notably, only a small part of the decline in growth that Latin American and other countries experienced after the late 1970s is accounted for by the drop in their investment. As I will argue in chapter 4, the ability to maintain macroeconomic stability in the face of often turbulent external conditions is the single most important factor accounting for post-1975 economic performance in the developing world. The countries that were unable to adjust their macroeconomic policies to the shocks of the late 1970s and early 1980s ended up experiencing a dramatic collapse of productivity (which shows up in negative rates of TFP growth during the 1980s).

The countries that fell apart did so because their social and political institutions were inadequate to bring about the bargains required for macroeconomic adjustment—they were societies with weak *institutions of conflict management*. I use this terminology to indicate that

adjusting to changing circumstances, and to external shocks in particular, requires the presence of institutions that can mediate distributional conflicts in society. In the absence of such institutions, the policy adjustments needed to re-establish macroeconomic balance are delayed, as labor, business, and other social groups block the implementation of fiscal and exchange-rate policies. The result is that the economy finds itself confronted with high inflation, scarcity of foreign currency, and a myriad of other bottlenecks. Societies with deeper cleavages (along ethnic, income or regional lines) are particularly susceptible to policy paralysis of this sort, making institutions of conflict management all the more important in such societies.

In chapter 4, I will illustrate and provide evidence for these ideas. I will argue, on the basis of systematic evidence, that some of the more important institutions of conflict management are the following: participatory political institutions, civil and political liberties, free labor unions, non-corrupt bureaucracies, high-quality independent judiciaries, and mechanisms of social insurance such as safety nets. These kinds of institutions are important both for managing turbulence in the world economy and for countering the possible widening of inequality that openness brings.

Implications for international governance

This essay focuses mainly on the challenges faced by *national* policy makers. My primary concern is with domestic policies that foster national economic development, including those that complement openness to international trade and capital flows. While my conclusions have implications for the governance of the international economy and the practices of multilateral organizations in particular, I will not develop these implications in detail. The

question of how to reform international institutions so as to provide a supportive environment for the approaches outlined here is largely outside the scope of my analysis.

However, the concluding chapter briefly discusses a key lesson for international economic governance, which I repeat here. It is not realistic to expect that national development efforts will converge on a single model of “good economic behavior”; nor is it desirable that they do so. Correspondingly, the rules of the international economy must be flexible enough to allow individual developing countries to develop their own “styles” of capitalism, in the same way that countries such as Japan, Germany, and the U.S. have in the past evolved their own different models.

Concluding remarks

Development policy is prone to fashions. During the 1950s and 1960s, when import-substitution was in vogue, there was excessive optimism about what government interventions could achieve (Krueger 1993, chap. 3). Now that outward-orientation is the norm, there is excessive faith in what openness can accomplish. Early on, planning models emphasized capital accumulation at the expense of price incentives and the role of markets. Today the importance of investment is consistently downplayed. The swing of the pendulum from one extreme to another creates blind spots, risking yet another unproductive change in fashions.

In reality, economies that have been successful have been those whose governments have done a whole host of things well simultaneously. Successful economies have combined a certain degree of openness with policies that are conducive to investment, macroeconomic stability, and prudent management of capital inflows. Countries that have relied on any one of these alone have typically faltered over the longer run. The policy lesson is a simple one, but it is often overlooked.

The arguments I make in this essay have the implication that the terms around which openness is discussed in the developing countries needs to change. The emphasis has to shift away from encouraging exports and DFI to thinking about how imports—particularly imports of ideas, of investment and intermediate goods, and of institutions—can enhance growth opportunities. Policy makers have to understand that integration into the world economy is unlikely to bring long-term growth on its own. They have to complement openness with other policies, including an explicit and coherent domestic investment strategy.¹⁰ They have to realize that openness raises the premium on high-quality domestic institutions of conflict management, and that strengthening such institutions goes beyond the standard economic remedies and adjustment packages.

Governments and policy advisors alike have to stop thinking of international economic integration as an end in itself.¹¹ Developing nations have to engage the world economy on their own terms, not on terms set by global markets or multilateral institutions. As I will illustrate in subsequent chapters, successful economies in the past have been those that have taken a strategic and differentiated approach to openness. There is little reason to believe that the future will look any different.

¹⁰ For a recent and forceful statement on the need to complement trade liberalization and privatization with other reforms, see Stiglitz (1998).

¹¹ A good example of putting the trade cart before the development horse is the following recommendation from the OECD (1997, 18): "Though the speed and sequencing of liberalization will have to be determined by each country in light of its particular circumstances, policies should be geared to the ultimate objective of full integration into the global financial system" (emphasis added). Note the grudging concession to "speed and sequencing."

Chapter 2: Openness in Perspective

Why is openness important?

The answer to the question posed by this section's title may seem evident. Ask policy makers in Latin America, East Asia, or Eastern Europe about their reasons for opening up, and you will hear a long list of benefits. Most likely, these benefits will revolve around the importance of exports and foreign investment (DFI). Hence you might be told that exports and DFI generate growth; that they create employment; that they produce learning spillovers which enhance the productivity of the economy; and that no country can afford to remain closed in a "globalized" world economy.

In fact, these are the wrong reasons for maintaining an open economy. The benefits of openness lie on the import side, rather than the export side. In general, there is little reason to believe that one dollar of exports will contribute to an economy more than a dollar of any other kind of activity; nor to believe that one dollar of DFI will contribute more than a dollar of any other kind of investment. As I will discuss below, the evidence that exports and DFI per se generate economic growth, or that they produce significant positive spillovers, is scanty. Furthermore, the belief that exports can increase the overall level employment in an economy is a mercantilist fallacy, which, taken to its logical conclusion, leads to a preference for trade surpluses.

The starting point for any serious discussion of trade is the theory of comparative advantage. According to the theory, trade allows a more efficient use of an economy's resources by enabling imports of goods and services that could otherwise only be produced at home at higher resource costs. In particular, trade enables developing countries to import capital and intermediate goods—critical to long-run economic growth—that would be quite expensive

to produce locally. As the theory emphasizes, exports are important only insofar as they allow imports to be paid for. Exports are the “price” that an economy pays for having access to imports; they are a means, not an end.

More recent theories of “endogenous growth,” going beyond models of static comparative advantage, have substantially enriched our understanding of the channels through which trade can affect dynamic performance. These theories significantly widen the range of possibilities, but they do not create a presumption that openness spurs technological capabilities and long-run growth. On the plus side, the new models demonstrate how the benefits of scale economies reaped through participation in world markets and imports of technology can cumulate into faster growth in the longer term. On the minus side, they underscore the risk of specialization in technologically less dynamic sectors, sectors in which developing countries might have an initial comparative advantage.

These are points that are well understood by economists, and they are not controversial. In their role as policy advocates, however, many economists have been too quick to latch on to pro-trade arguments that are weakly based on theory and ill-supported by evidence. Just as the advantages of import-substitution policies were overstated in an earlier era, today the benefits of openness are oversold routinely in the policy-relevant literature and in the publications of the World Bank and the IMF. This is counter-productive both because it induces over-reliance on trade policy in national strategies for economic development, and because it increases the risk of a backlash against openness on the part of policy makers (and their constituencies) when the touted benefits fail to materialize.

Hence it is important to be clear about what openness can and cannot do. Policy makers need to focus on the real benefits, and not get distracted by the more elusive and hypothetical

gains. I emphasize four types of “imports” that openness enables countries to purchase: ideas, goods and services, capital, and institutions.

Importing ideas

Ideas on organizing the process of production, manufacturing a new product, and (perhaps most fundamentally) identifying a commodity for which there exists a latent demand are central to economic growth. As Paul Romer (1993) has usefully emphasized, discussions of growth tend to focus on “objects” at the expense of the role played by “ideas.” One advantage of backwardness is that ideas can be borrowed (i.e., imported) from richer countries: the wheel does not have to be re-invented in every country. Hence the ability to import ideas is of particular advantage to countries that lag behind the technological frontier.

In his magisterial survey of world economic history, David Landes (1998) has argued that openness to ideas originating from abroad is a key distinction between “cultures” that prospered materially (such as those in Western Europe) and those that did not. Importing ideas is different from importing goods. One can imagine countries that import high levels of consumer goods, yet fail to adopt and adapt the techniques developed by their trade partners—which is in fact the interpretation that Landes would place on Chinese and Middle Eastern economic history. Conversely, South Korea and Taiwan have been very successful at importing ideas despite wide-ranging trade restrictions throughout the 1960s and 1970s. Successful importation of ideas requires individual skills and organizational capacity in the importing countries.

Romer (1993) distinguishes between strategies of “using ideas” and of “producing ideas.” He points to Taiwan as an example where the government has been successful in stimulating the domestic production of ideas by relying on a judicious mix of bureaucratic

interventions and international trade. He compares this case favorably to that of Mauritius where the government has instead relied on investments by multinational enterprises in an export processing zone—a strategy of “using ideas.” The first strategy produces greater economic rewards, but, as Romer emphasizes, it is also riskier because of the dangers of rent seeking and protectionism.

Importing goods and services

The traditional case for the gains from trade is based on comparative advantage: countries can increase their levels of well-being by importing those goods and services which they produce relatively inefficiently and exporting those which they produce relatively efficiently. While the logical case for gains from trade is airtight, it is important to view these gains in their proper perspective. First, as stated, the gains are of the static variety: that is, they raise the level of income, but not its long-run rate of growth. Second, under the standard perfectly-competitive/constant-returns-to-scale scenario, the quantitative magnitude of the gains tends to be small—no more than a couple of percentage points of income in most cases.

More recent theoretical models of trade under conditions of imperfect competition and/or increasing returns to scale generate a much wider range of outcomes, as mentioned above. In particular, opening up to trade can result in increased rates of economic growth in so-called endogenous-growth models. In the policy literature, this possibility is often used as an argument for a trade-growth linkage. What is less widely appreciated, however, is that endogenous-growth models can also yield permanently reduced rates of growth, as when trade pushes an economy to specialize in sectors with no dynamic scale or other benefits. The theoretical relationship between trade and growth is fundamentally ambiguous.

In practice, there are two potential channels through which trade openness can have a significant positive effect on long-term economic performance in developing countries, one having to do with capital-goods imports and the other with intermediate-goods imports. A few words about each will clarify the argument.

Imports of investment goods

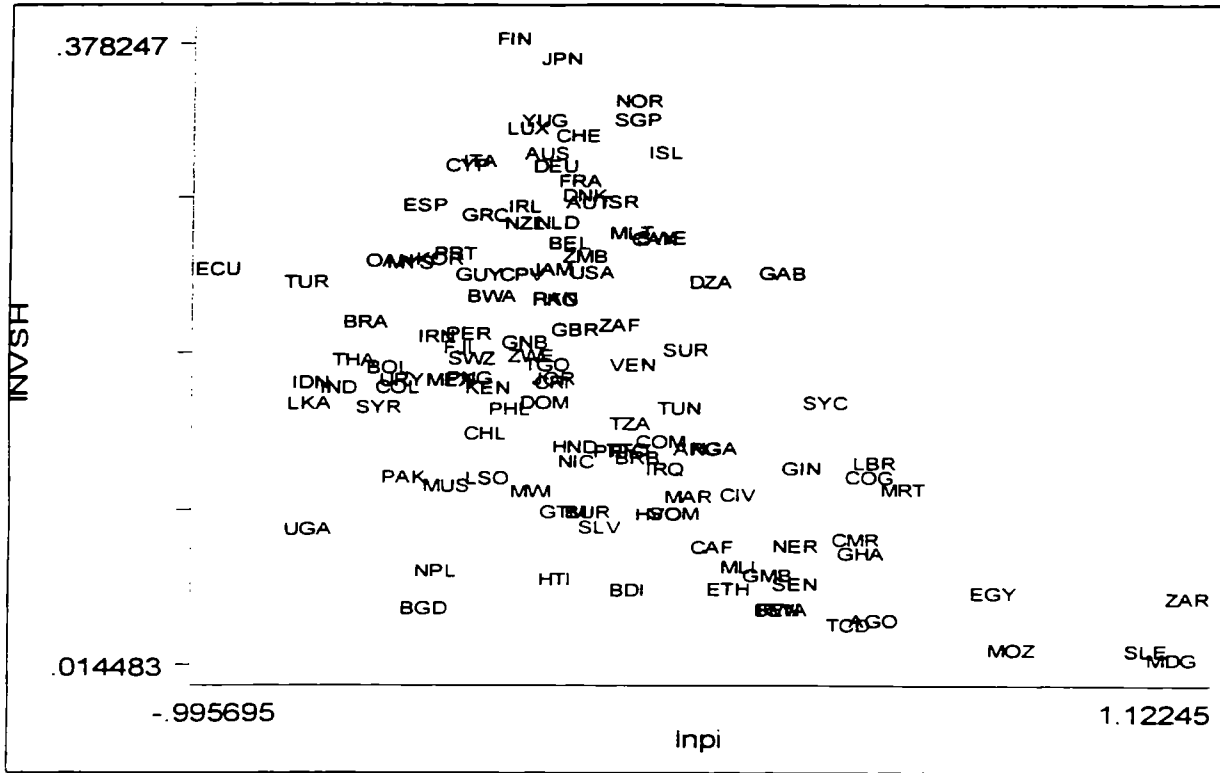
For most developing countries, raising long-term growth requires an increase in the investment rate. Cross-national evidence indicates that the social returns to equipment investment are particularly high: well over 50 percent according to one careful study (Temple 1998; see also de Long and Summers 1991). Since developing countries lack a comparative advantage in producing capital goods, trade restrictions in such industries tend to be detrimental to growth. Trade protection raises the relative price of capital goods, and reduces the level of real investment that is attainable for any level of savings.¹²

To take a numerical example, consider two countries with identical total savings rates (domestic plus foreign) of 15 percent of national income. Suppose country A imposes no import restrictions on capital goods, while B does, so that the domestic price of capital goods exceeds world prices by 20 percent in country B. In real terms, the investment that country B can undertake amounts to only 12.5 percent of its income ($0.15/1.20$), compared to 15 percent in country A. Indeed, countries where the relative price of investment goods has been kept high by trade restrictions and other policies tend to have lower investment rates, when investment and output are measured at international prices (see Figure 2.1). A ten percent increase in the price

¹² Many developing countries try to offset these costs by providing import-duty exemptions to imports of capital goods.

Figure 2.1

Relationship between price of investment goods and investment share in GDP, 1960-89



Source: Penn World Table 5.6.

Notes: lnpi is the log of the price of investment goods in a country relative to the U.S., and INVSH is the investment/GDP ratio in international prices.

of investment goods is associated with a one percentage point reduction in the real investment share in GDP.

Therefore, countries that close themselves off from imports of capital equipment shoot themselves in the foot. In the postwar period, many Latin American and African countries fell into this trap. The paradigmatic case is Argentina, where capital equipment cost two to three times more than it did in the United States (see Taylor 1996, 1997).

Imports of intermediate goods

The relationship between intermediate-goods imports and economic growth is less direct, but potentially as important. In any modern economy, production of manufactured goods relies on a large range of specialized inputs, many of which exhibit increasing returns to scale and require a high level of technological expertise. Developing countries, especially those with small domestic markets, cannot rely on a local supply of most of these specialized intermediate inputs. Trade impediments, which restrict the availability of such inputs, have adverse effects on the productivity of domestic manufacturing firms, and these cascade throughout the economy.

Standard economic analysis focuses on the effect of trade restrictions on the level of existing activities. Romer (1994) has argued that one of the most important ways in which trade policy affects welfare in developing countries is by preventing the establishment of new activities. In the presence of fixed setup costs, the latter entails the loss of potentially quite large rectangles of consumer or producer surplus—rather than the relatively small Harberger's triangles of conventional analysis. Trade restrictions that make it not worthwhile for individual entrepreneurs to import key inputs and components—with the result that these become unavailable to the home economy—can have welfare costs that are several times larger than the costs suggested by the standard partial-equilibrium.

Importing capital

In principle, the ability to borrow from (and sometimes lend to) international capital markets is an important source of gain for developing countries. Almost by definition, developing countries are capital-poor. All else being the same, this implies a rate of return to capital that is higher than elsewhere. A flow of capital into developing countries can therefore foster investment and growth. Second, borrowing allows the smoothing of consumption in response to the temporary shocks that often buffet poor economies—such as crop failures, natural disasters or temporary terms-of-trade declines. Third, international capital markets allow households to diversify their portfolios and achieve a better mix of risk and return.

In practice, foreign borrowing has often been a mixed blessing at best. For one thing, there is very little evidence that capital inflows crowd in additional domestic investments. In fact, the cross-national evidence indicates that a large portion of capital inflows substitutes for investments that would otherwise be financed domestically (see Bosworth and Collins 1998). Moreover, partly because of mismanagement on the part of heavily-indebted governments and partly because of the herd instinct that dominates lenders' behavior, periods of sustained foreign borrowing frequently have ended in financial crises. The debt crisis of 1982, the Mexican Peso crisis of 1994, and the Asian financial crisis of 1997 are the most recent examples of such episodes.

These experiences illustrate the difference in the way that markets for financial assets operate. While markets for goods and services are rarely textbook-perfect, they do operate in most instances with a certain degree of efficiency and predictability. In financial markets, market failures arising from asymmetric information, incompleteness of contingent markets,

bounded rationality, and occasional irrationality are endemic. The consequences have been highlighted in the academic literature:

- Asymmetric information combined with implicit insurance results in moral hazard, adverse selection, and excessive lending for risky projects.
- A mismatch between short-term liabilities and long-term assets leaves financial intermediaries vulnerable to bank runs and financial panic, a problem that is particularly severe in cross-border transactions where there is no international lender of last resort.
- When markets cannot observe the intrinsic quality of money managers, these managers are likely to place too little weight on their private information and exhibit herd behavior, resulting in excess volatility and contagion effects.
- Since asset values are determined by expectations about future returns, the dynamics of asset prices can be quite rich, exhibiting bubbles and “peso problems.”¹³

Such problems are particularly severe where short-term capital flows—of maturity less than a year—are concerned. Failure to roll over short-term debts in case of financial panic becomes more likely, and generates much more pain, in a country that has relied excessively on short-term flows. Compare, for example, two countries with debt-GDP ratios of 40 percent. Let short-term debt make up 80 percent of the first country’s liabilities, and 20 percent of the second country’s. In case foreign creditors refuse to roll over the debt, the first country has to turn over 36 percent of its GDP to its foreign creditors in one year, a burden that few countries would be able to shoulder. The second country has to transfer eight percent of its GDP, a significant but manageable amount.

¹³ The “peso problem” refers to a process whereby the price of an asset (e.g., a currency) appreciates in order to balance out the risk that there will be a discrete depreciation at some point in the future.

The lesson is that reliance on direct foreign investment and long-term bond finance is comparatively much safer. Openness to international capital flows can be especially dangerous if the appropriate controls, regulatory apparatus, and macroeconomic framework are not in place. But even with such safeguards, short-term flows can prove erratic and risky.

Importing institutions

International trade in goods, services, and capital entails arbitrage in prices: price differentials across national markets erode as a consequence of international integration. But international trade often entails another kind of arbitrage as well: arbitrage among national institutions. This kind of arbitrage is more subtle, and for that reason less discussed: but it is no less real.

Sometimes the arbitrage—institutional convergence—is the outcome of deliberate policy actions to “harmonize” a country’s economic and social institutions with those of the trade partners.¹⁴ Membership in the WTO, for example, requires the adoption of a certain set of institutional norms: non-discrimination in trade and industrial policies; transparency in the publication of trade rules; WTO-consistent patent and copyright protection; and so on. Similarly, membership in the European Union requires the adoption of wide-ranging legal and bureaucratic requirements set down in Brussels. At other times, institutional arbitrage is the result of the working out of market forces. Mobility of employers around the world, for example, makes it harder to tax corporations, and tilts national regimes towards the taxation of “non-traded” goods and factors (such as labor). Financial integration raises the premium for

¹⁴ This is called “deep integration” by Lawrence (1996), to distinguish it from the “shallow integration” that takes place with the elimination of barriers to trade at the border.

macroeconomic stability and makes central-bank independence look more desirable. Finally, openness can change national institutions by altering the preferences that underlie them. Civil liberties and political freedoms are among the most important imported concepts in the developing world; the demands for democracy to which these ideas give rise are a direct product of openness in this broad sense.

Arbitrage in markets for goods and capital, in the absence of second-best complications, is associated with normatively desirable outcomes, as such arbitrage increases efficiency. One cannot make the same presumption where arbitrage in institutions is concerned. There are no theorems that state that institutional convergence, harmonization, or “deep integration” (a la Lawrence 1996) through trade is inherently desirable. While many of the examples cited above involve outcomes that are desirable (greater democracy for instance), not all possible outcomes are. Think of countries that face the prospect of adopting the EU’s Common Agricultural Policy or its anti-dumping regime. It all depends on the circumstances and how national governments are able use such circumstances.

One way that governments can use institutional arbitrage to good effect is to enhance the credibility of domestic institutions. For example, the new disciplines imposed on developing-country governments by the WTO—in the areas of tariff bindings, quantitative restrictions, services, subsidies, trade-related investment measures (TRIMs), and intellectual property—can be viewed as helping these governments to overcome traditional weaknesses in their style of governance. These disciplines impose a certain degree of predictability, transparency, rule-bound behavior, and non-discrimination in areas of policy often subject to discretion and rent-seeking (Rodrik 1995a). In the same vein, perhaps the greatest contribution of NAFTA to the Mexican economy was the element of irreversibility and “cementing” that the agreement has

contributed to the country's economic reforms. In Europe, the accession of Greece, Spain and Portugal to the EU has made a return to military dictatorship virtually unthinkable.

However, imported institutions can also turn out to be ill-suited or counter-productive. Many of the labor standards that some labor groups in the North would like developing countries to adopt—such as higher minimum wages or restrictions on some kinds of child labor—fit possibly in this category. The new patent restrictions called for by the IPR agreement of the WTO are at best a mixed blessing for countries like India, for example, which have so far benefited from cheap pharmaceuticals. A similar argument can be made about the tightening of environmental standards in developing countries. There are drawbacks, therefore, in harmonizing developing-country institutions with those in the advanced countries.

Export fallacies

If imports are important to economic development, so are exports, since exports help pay for imports. In fact, this is exactly the right way to think of exports: they are a means, not an end. Since much of current thinking on trade policy in developing countries (and elsewhere) puts the cart before the horse by vastly overstating the role of exports, it is useful to elaborate a bit on this point.

Export (and DFI) fetishism

Very few countries have grown quickly over the last two decades without experiencing an increase in the share of domestic output that is exported. Table 2.1 lists the 25 fastest growing developing countries over the 1975-94 period, excluding those for which constant-price export

Table 2.1

Export-GDP ratios in fastest growing countries, 1975-94
(at 1987 constant prices)

	per-capita GDP	export-GDP ratio		
	growth 1975-94 (percent)	1975	1994	increase 1975-94
China	7.33	0.087	0.176	0.089
Korea, Republic of	6.95	0.208	0.424	0.216
Taiwan, China	6.56	0.316	0.538	0.222
Cyprus	6.05	0.247	0.521	0.274
Thailand	5.88	0.166	0.431	0.266
Hong Kong	5.76	0.729	2.098	1.369
Indonesia	4.93	0.377	0.246	-0.131
Malaysia	4.43	0.456	0.911	0.455
Chile	3.60	0.194	0.380	0.185
Lesotho	3.46	0.119	0.173	0.053
Egypt, Arab Rep.	3.17	0.240	0.217	-0.023
Pakistan	2.75	0.102	0.169	0.067
India	2.52	0.058	0.083	0.025
Colombia	2.07	0.150	0.208	0.058
Morocco	2.03	0.212	0.259	0.047
Bangladesh	2.00	0.059	0.131	0.071
Tunisia	1.98	0.305	0.445	0.140
Israel	1.85	0.245	0.357	0.112
Paraguay	1.69	0.199	0.590	0.391
Turkey	1.55	0.075	0.221	0.146
Uruguay	1.54	0.150	0.297	0.147
Dominican Republic	1.24	0.284	0.422	0.138
Myanmar	1.21	0.024	0.051	0.027
Mexico	1.13	0.108	0.299	0.191
Ecuador	0.99	0.280	0.353	0.073

Source: World Bank data.

data are unavailable. Only two countries among the 25 have experienced declines in export-GDP ratios at constant prices (Indonesia and Egypt), with many of the rest showing spectacular increases of ten percentage points or more. In this sense, increased export orientation has been a hallmark of practically all successful countries.

It is tempting to conclude from this kind of evidence that exports generally lead to or stimulate growth. Yet as the next table shows, this would be an erroneous inference. In Table 2.2, I have reversed the exercise and listed the 25 developing countries with the largest increases in export-GDP ratios over the same period. The list includes many from the previous table (including most notably the East Asian countries), but also many with undistinguished growth records. For example, suppose we take one percent growth in GDP per capita (per annum) as the criterion for modest success. Close to half (eleven) of the countries in Table 2.2 fall below this threshold, with five having experienced negative growth. The evidence is clear-cut: while countries that grow fast tend to experience rising export-GDP ratios, the reverse is not true in general.

The current emphasis on exports is in part a reaction to the neglect with which exports were treated under policies of import-substitution. In the presence of high levels of trade barriers, there is reason to believe that export levels (as well as imports) are sub-optimal, and that the economy-wide benefit from an additional dollar of exports exceeds a dollar. But with the worst trade restrictions gone in most countries outside of Sub-Saharan Africa, the efficiency case for favoring exports over other activities has disappeared as well.¹⁵

¹⁵ Note that when capital-good imports entail positive externalities, as I argue above, there might be a case for subsidizing them. This means that exports also might provide additional value to the economy to the extent that their receipts are used to purchase capital goods. But there is no guarantee that they would be. Export receipts can be spent on purchasing consumer goods or accumulating foreign assets.

Table 2.2

**Countries with largest increase in export-GDP ratios, 1975-94
(at constant 1987 prices)**

	export-GDP ratio			per-capita GDP growth 1975-94 (percent)
	1975	1994	increase 1975-94	
Hong Kong	0.729	2.098	1.369	5.76
Trinidad and Tobago	0.226	0.723	0.498	-0.12
Malaysia	0.456	0.911	0.455	4.43
Paraguay	0.199	0.590	0.391	1.69
Gabon	0.359	0.670	0.311	-4.11
Cyprus	0.247	0.521	0.274	6.05
Thailand	0.166	0.431	0.266	5.88
Philippines	0.161	0.386	0.225	0.42
Taiwan, China	0.316	0.538	0.222	6.56
Korea, Republic of	0.208	0.424	0.216	6.95
Mexico	0.108	0.299	0.191	1.13
Chile	0.194	0.380	0.185	3.60
Costa Rica	0.267	0.447	0.180	0.95
Swaziland	0.582	0.761	0.179	0.17
Cameroon	0.108	0.284	0.176	-0.62
Cote d'Ivoire	0.219	0.395	0.176	-2.87
Congo	0.370	0.520	0.150	0.67
Uruguay	0.150	0.297	0.147	1.54
Turkey	0.075	0.221	0.146	1.55
Tunisia	0.305	0.445	0.140	1.98
Dominican Republic	0.284	0.422	0.138	1.24
Rwanda	0.050	0.181	0.131	-3.29
Papua New Guinea	0.375	0.494	0.118	0.89
Israel	0.245	0.357	0.112	1.85
Mali	0.087	0.181	0.094	0.19

Source: World Bank data.

The intellectual case for exports nowadays revolves around the belief that exports provide a range of positive spillovers to domestic activities. Exports, it is claimed, are a source of learning and technological externalities for the home economy, and allow domestic producers to learn from sophisticated markets abroad. Such statements are commonplace in World Bank reports, for example, where they are typically asserted without much substantiation (see World Bank 1993, chap. 6, and 1998, chap. 2).

What does the evidence show? Many studies find that exporting firms are indeed technologically more dynamic, tend to have larger plants that better utilize scale economies, employ a higher-skill mix of workers, and generally outperform non-exporting firms. But these findings can be read in two different ways, with divergent implications for policy. We can interpret the evidence as support for the hypothesis that exporting activities are special along the stated dimensions. This then might constitute grounds for instituting policies that favor exports over other activities.¹⁶ Or we can take the position that the firms that are successful for other reasons tend to self-select into exporting activities (since that is what comparative advantage itself would suggest). In the latter case, exports would not require special treatment. The typical approach to date has been to document that exporters (or export-oriented sectors) in developing countries are superior along some technological dimension (say TFP growth), and then to jump to the first conclusion.

A number of recent studies have been more careful and have tried to sort out causality from correlation. Their conclusions suggest that the self-selection scenario is the more common one. For example, Clerides, Lach and Tybout (forthcoming) look at data from Colombia.

¹⁶ Might, because there are other issues that need to be resolved before an economic case for subsidizing exports can be made. In particular, one needs to identify a specific market failure. For example, technological dynamism per se does not call for intervention unless there are conventional externalities involved. Wage premia do not call for intervention unless they entail rents over and above returns to skills.

Mexico, and Morocco and find little evidence that efficiency benefits accrue from exporting activities per se. What seems to happen is that efficient producers are more likely to enter into export markets. Aw, Chung, and Roberts (1998) analyze TFP growth in Taiwan and Korea and its relation to exporting. They find little evidence of learning from exporting in these two countries, even though exporters on average have higher productivity than non-exporters. In particular, there is no evidence that firms with a continuous export record experience an increasing productivity advantage over firms that never export.

In a number of careful studies, Bernard and Jensen (1995, 1998) have reached similar conclusions for the United States: while exporting plants outperform non-exporting plants in terms of size, productivity, and growth, there is no evidence that exporting status per se is responsible for these outcomes. Good performance seems to determine exporting status. Causality goes from productivity to exports, and not vice versa. As Bernard and Jensen (1995, p. 111) summarize their findings: "current exporters have been successful in the past—it is likely that success has helped them become exporters—but there is no guarantee that current exporters will continue to outperform other establishments in the future." On the other hand, a study by Bigsten *et al.* (1998) using a sample of firms from four African countries (Cameroon, Kenya, Ghana, and Zimbabwe) finds that exports have a significant impact on subsequent performance on technical efficiency, even when past levels of efficiency are controlled for.

Note, moreover, that even studies that find a positive relationship between exporting history and subsequent productivity performance (such as Bigsten *et al.* 1998) say nothing at all about the presence of spillovers (or positive externalities) across firms. In the absence of such spillovers, there is no economic argument for government policies that favor export activities—

the reason being that the productivity benefits from exporting would be fully internalized by the firms in question and automatically provide the needed inducement for exporting.

In any case, these findings are indicative but preliminary. Future studies are likely to uncover a richer set of interactions between exports and performance. In the meantime, policy makers are well advised to discount claims of special significance for exports. We have no evidence that a dollar of exports contributes any more (or any less) to an economy than a dollar of any other kind of productive activity.

Much the same can be said about direct foreign investment as well. The attitude of many developing-country policy makers towards DFI has undergone a remarkable turnaround in the last couple of decades, even more so than in the case of exports.¹⁷ Multinational enterprises used to be seen as the emblem of dependency; they have now become the saviors of development. Today's policy literature is filled with extravagant claims about positive spillovers from DFI. These spillovers include technology transfer, marketing channels, superior management, and labor training.¹⁸ Once again, the hard evidence is sobering. Systematic plant-level studies from countries like Morocco and Venezuela find little in the way of positive spillovers (see Harrison 1996). At the national level, the effect of DFI on economic growth tends to be weak, and disappears as more country characteristics are controlled for (Bosworth and Collins 1998). Much, if not most, of the correlation between the presence of DFI and superior performance seems to be driven by reverse causality: multinational enterprises tend to locate in the more productive and profitable economies (and niches thereof).

¹⁷ For a very useful and insightful account of the relationship between multinational enterprises and host governments, see Vernon (1998). Vernon argues that there will be increased troubles ahead in this relationship.

¹⁸ For example, a box titled "Technological spillovers in the sewing machine industry in Taiwan (China)" in World Bank (1997, chap. 2) relates the story of the establishment of the U.S. company Singer in Taiwan. Yet upon closer reading, the spillovers in question turn out to be conventional input-output linkages and labor training. No evidence is presented for the presence of non-pecuniary externalities.

The rule of thumb for DFI, as with exports, should be this: absent hard evidence to the contrary, one dollar of DFI is worth no more (and no less) than a dollar of any other kind of investment. One implication is that subsidies and tax credits that favor foreign over domestic investment need serious reconsideration. A particularly pernicious form of subsidy to DFI is the erection of trade barriers so as to guarantee the foreign investor a protected domestic market—a concession that foreign investors are often able to extract from governments that are too keen on DFI. Such schemes have to be viewed as value subtracting for the economy as a whole (as per Brecher and Diaz-Alejandro 1977), unless a strong case can be made for the presence of positive externalities deriving from the investment in question.

Export pessimism

One of the pieces of conventional wisdom that shaped post-war development thinking was that developing-country exports, mostly natural-resource based products, were largely insensitive to price policies. This was part of the reason why governments in Latin America and elsewhere de-emphasized exports, and followed inward-oriented policies. In reality, such fears have proved to be unfounded. Countries that made a concerted effort to enhance the profitability of exports—via exchange-rate depreciation, export subsidies, or duty-free treatment of inputs for export production—experienced dramatic export booms. The list includes not only the usual East and Southeast Asian suspects, but also countries like Brazil after the late 1960s, Mauritius since the early 1970s, Turkey after 1980, and Chile since the mid-1980s. Neither low elasticities nor Northern protectionism has proved a serious obstacle to developing-country exports. Cross-

national studies generally conclude that the real exchange rate (its level as well as its variability) is a particularly significant determinant of export performance in developing countries.¹⁹

However, policy makers in many low-income countries—particularly those in Sub-Saharan Africa—continue to have misgivings about their export prospects. I will discuss the case of Africa in more detail in chapter 5. Here, I use a couple of non-African cases to illustrate how export pessimism is often misplaced.

Taiwan and Chile: Two unlikely cases of export success

In 1954, the economists T.C. Liu and S.C. Tsiang were invited by the Taiwanese government to provide advice on economic policy.²⁰ At that time, Taiwan had an overvalued exchange rate, high levels of trade restrictions, and negative real interest rates—a classic combination of import-substitution syndromes. Liu and Tsiang promptly recommended devaluation coupled with trade liberalization. Taiwanese government officials objected, in line with then-conventional wisdom, that such policies would prove futile where exports were concerned. Indeed, Taiwan had even less reason to expect an export response than most low-income countries today. In purchasing-power adjusted terms, Taiwan was a poorer economy in 1955 than most African countries are presently. Two commodities (sugar and rice) accounted for almost 80 percent of the island's exports, and moreover both were under quantitative ceilings imposed by international agreements. Sugar exports were regulated by the international sugar agreement, and rice exports (which went exclusively to Japan) were fixed by negotiation between the two governments. Where would exports come from?

¹⁹ See Elbadawi (1998) for a recent careful study focusing on non-traditional exports. Interestingly, Elbadawi finds that imports of capital goods are also strongly associated with non-traditional export performance. I will emphasize the link between investment and exports in the next chapter.

²⁰ This account is based on Tsiang (1984).

Liu and Tsiang replied that “even if the traditional major exports were confronted with foreign demands of little elasticity, there must be hundreds of new products that could be produced with cheap labor supply and readily sold in [other] countries” (Tsiang 1984, p. 306). The two economists were right: from the late 1950s on, Taiwanese exports grew phenomenally, and by 1970, industrial products made up almost 80 percent of her exports (up from ten percent in 1955). As I will discuss in chapter 3, trade and exchange-rate policies were not the only thing that made this export “miracle” possible: the Taiwanese government also had a coherent investment strategy that spurred growth and diversified the economy. The moral of the story is that current export structure is a very poor indicator of future export prospects, once anti-export bias is removed and the other fundamentals are in place.

Taiwan had some advantages. In particular, it had a relatively abundant labor force, quite well educated for a country at that level of development, and therefore an underlying comparative advantage in manufactured goods.

Chile provides a recent example of successful export performance and diversification based on natural resources. In 1970, copper accounted for 77 percent of Chilean exports. Since then, and especially since 1985 when the depreciation of the real exchange rate made exports more profitable, non-traditional exports have expanded greatly. While close to 90 percent of Chilean exports are based on natural resources, copper’s share has declined to below 50 percent, and the most rapid increases have been generated in agricultural products (mainly fruit such as grapes and apples), forestry products (sawn wood and wood pulp), and fish. The share of exports in GDP has gone from 14 percent of GDP in 1970 to 29 percent in 1985 and to 39 percent in 1995. This process of export growth and diversification was enabled not only by open trade policies and (after the mid-1980s) a competitive exchange rate, but also by sector-specific

government policies that encouraged technology transfer and investment in non-traditional areas (see Meller 1995).

Export pessimism can be a self-fulfilling prophecy, when anti-export bias is removed half-heartedly and reforms lack credibility. But, regardless of whether a country's comparative advantage lies in manufactures or natural resources, the evidence shows that exports are responsive to incentives and they do take off under the correct circumstances. Export diversification often occurs in tandem with export expansion, but it typically also requires complementary investment policies.

Concluding remarks

The thinking on trade among development specialists has gone from one extreme to the other during the last four decades. The belief that trade volumes are inelastic and that the developing nations would face great difficulty in making inroads in world markets for non-traditional products used to be the conventional wisdom in the aftermath of the Second World War. Multinational enterprises were viewed as agents of exploitation. Nowadays trade and foreign investment have become the miracle cure for all that ails poor countries.

The good news, as I have suggested in this chapter, is that the export pessimism of the past has proved to be quite unjustified. The bad news is that trade and foreign investment are not all that their boosters advertise. The instinctive tendency of many policy makers nowadays to place priority on exports (over other types of production) and direct foreign investment (over other forms of investment) needs to be seriously challenged. Policy makers should avoid becoming knee-jerk globalizers. As I will argue in the next chapter, it is domestic investment that ultimately makes an economy grow, not the global economy.

Chapter 3: Investment Strategies

Two country vignettes

Consider how the growth prospects for two actual countries, which I will call countries A and B, were evaluated by outside observers early in their development history.

Country A was widely viewed as an economic basket case during the 1950s. The economy had virtually no manufacturing capacity, the investment rate was below ten percent of GDP, and foreign aid financed nearly 70 percent of imports. The economy suffered from inflation, large black-market premia, and other symptoms of macroeconomic instability. There were no natural resources to speak of. Foreign advisors routinely judged the local labor force to be lazy and ill-prepared for the rigors of industrial production. The bureaucracy was viewed as incompetent and corrupt, rife with rent-seeking behavior in the allocation of licenses and permits. Few observers thought that the economy would ever be able to reduce its dependence on foreign assistance, let alone grow at respectable rates.

Country B was a monocrop economy, heavily dependent on sugar exports, facing a population explosion. The country had no natural resources or industrial base, and, as an island economy located far from international shipping lines, was geographically isolated. In 1961, a committee headed by a future Nobel Prizewinner in economics reached quite pessimistic conclusions about the future of the island. Unless something was done about the rapid growth of the population and the labor force, the committee's report warned, the country was headed for a catastrophic situation. When the country became fully independent in 1968, the economic problems it faced were compounded by a deteriorating external terms of trade, ethnic strife and riots, labor strikes, and a serious challenge being mounted by Marxist political groups.

The two countries are South Korea and Mauritius, and we now know that in fact both countries did quite well for themselves.²¹ Per-capita GDP has grown at 6.8 percent in Korea since 1960 and at 4.1 percent in Mauritius since 1968. Poverty has been substantially alleviated, and social and human indicators have improved tremendously. Despite the pessimistic prognosis early on, the two countries are among the success stories of economic development. They have left behind most of the countries that were judged in the 1950s and 1960s to have better economic prospects.

It is no secret that the opportunities offered by international trade had much to do with the success of these two economies. South Korea has turned itself into an export powerhouse, having metamorphosed from an insignificant producer of simple labor-intensive products into a major exporter of semi-conductors. Mauritius has a less distinguished trading record, but without the ability to export garments produced in its export-processing zone (EPZ), the island would surely be a lot poorer than it is currently. In both economies, the volume of exports has expanded faster than GDP—at 17.2 percent per annum in Korea (since 1960) and 5.2 percent in Mauritius (since 1968).

While trade was undeniably important, in neither case was superior economic performance the result of a simple opening up to trade and foreign investment. The principal element behind Korea's success was the government's ability to engineer a significant increase in the private return to investment. In Mauritius, the key was the channeling of a temporary boom in sugar profits into domestic investment via the creation of an EPZ. Where trade liberalization is concerned, the path taken by the two countries differed substantially from the rapid, across-the-board liberalization undertaken more recently in Latin America and typically

²¹ On Mauritius, see Wellisz and Saw (1993). The Nobelist in question is James Meade (Meade 1961).

recommended by the Bretton Woods institutions. Both countries liberalized in a gradual and partial manner throughout the 1980s, and did so in tandem with other policies that maintained high levels of investment while keeping the social peace.

Heterodox opening in Mauritius

Mauritius owes its success to an important extent to the creation in 1970 of an export-processing zone (EPZ) operating under free-trade principles. Enterprises operating under the EPZ—which entails no particular geographic designation—were provided tariff-free access to imports of machinery and inputs, free repatriation of profits, a ten-year tax holiday (for foreign investors), and “an implicit assurance that labor unrest would be suppressed and wage increases would be moderate” (Romer 1993, 77). The EPZ enabled an export boom in garments to European markets, where Mauritians could export quota-free. In 1971, there were a mere nine enterprises in the EPZ, employing 644 people. Five years later, there were 85 EPZ enterprises, employing 17,171 workers, and making up 13 percent of the island’s exports (Wellisz and Saw 1993, p. 241). Yet Mauritius has combined this EPZ with a domestic sector that was highly protected until the mid-1980s. Gulhati (1990, Table 2.10) reports an average effective rate of protection (ERP) for manufacturing in 1982 of 89%, with a range of -24 to 824% (see also Milner and McKay 1996, 72-73).

These high levels of protection were the legacy of the policies of import-substituting industrialization (ISI) followed during the 1960s. Under the Development Certificates (DC) scheme, local industrialists had been provided with tax holidays and protection from imports via tariffs and quantitative restrictions. A range of industries was set up using these incentives. The

industrialist class thereby created was naturally opposed to the opening up of the trade regime.

The EPZ scheme provided a neat way around this difficulty. Wellisz and Saw (1993) make the point nicely in this account:

A completely outward reorientation was politically unfeasible in the 1970s ... since protection was the key to the prosperity of the import-substituting industry and DC certificate holders constituted a powerful lobby. But the DC certificate holders were not disturbed by the formation of an export-oriented enclave: on the contrary, they welcomed it as another potential source of profits. Mauritian labor also favored economic segmentation: the high-wage sector—sugar and import-substituting industries—constituted a male enclave. The EPZ industries employed women, whose earnings supplemented family incomes and who did not compete with the men. For the export-oriented industries, too, the enclave solution had obvious advantages in that the quasi-extraterritorial status provided a degree of protection against the government's dirigiste tendencies. (Wellisz and Saw 1993, 242)

This passage illustrates the political advantages of the two-track strategy. The creation of the EPZ generated new opportunities for trade and employment (for women), without taking protection away from the import-substituting groups and from privileged male workers. The segmentation of labor markets was particularly crucial, as it prevented the expansion of the EPZ from driving wages up in the rest of the economy, and thereby disadvantaging import-substituting industries.²² New profit opportunities were created at the margin, while leaving old opportunities undisturbed. There were no identifiable losers.

A crucial part of the story is that the EPZ export boom was predicated on a substantial investment in manufacturing capacity during the early 1970s, without which there would have been little garment production to export. The economy's investment rate rose from below 15 percent in the late 1960s to 30 percent a decade later. Where did this investment come from?

It did not come from abroad. In this respect, the experience of Mauritius is quite different from that of Singapore, which has relied heavily on foreign investment. In the early stages of the

²² According to Wellisz and Saw, this segmentation lasted until the mid-1980s.

Mauritian EPZ, investments were financed virtually exclusively from domestic savings. This is shown clearly in Figure 3.1, which displays the domestic investment and savings rates for the Mauritian economy. The increase in investment in the early 1970s was more than matched by the increase in domestic savings. In fact, Mauritius did not rely on net foreign savings to any significant extent until 1976, well after the EPZ boom was under way. As late as 1984, only 57 percent of the capital stock was owned by foreigners, a far lower share than is usual for EPZs around the world (Hein 1989).

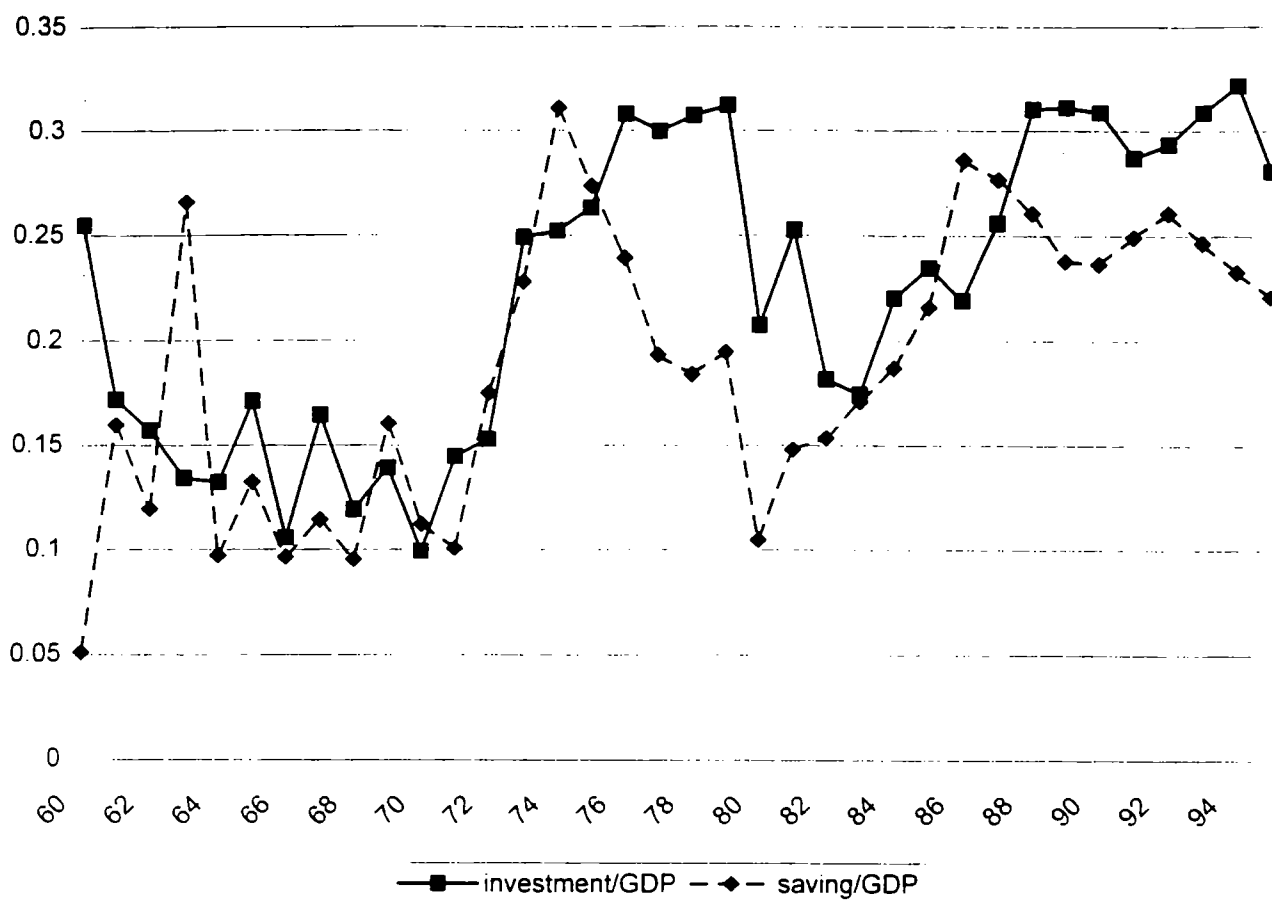
The increase in domestic savings was in turn the result of a fortuitous improvement in the island's terms of trade. World sugar prices began to rise in 1971, and the prices received by sugar producers more than tripled between 1972 and 1975 (Wellisz and Saw 1993, 235). By 1976, the trend was reversed, and domestic savings collapsed. But the spurt in the first half of the 1970s was critical in generating the funds that were then invested in the new export-oriented enterprises. The presence of strict foreign exchange controls ensured that the savings would be invested domestically (Hein 1989). The establishment of the EPZ just as sugar prices began their rise was a lucky coincidence that set the stage for an investment-export boom. Without the EPZ, there is a good chance that the investments would not have taken place, or else that they would have been wasted in high-cost, inward-looking projects. But without the increase in domestic savings and investment, the EPZ would not have been nearly as successful as it has been.

While foreign investment did not play a major role in the early success of the EPZ, the expertise brought by the entrepreneurs from Hong Kong who established themselves in the Mauritian EPZ was arguably decisive. As Romer (1993, 78) emphasizes:

[the] entrepreneurs did bring a crucial array of ideas about the textile and garment business, including ideas on the specific kind of equipment to use, how to manage a small factory, how to manage relations with textile importers in the industrial countries, how to successfully exploit loopholes in quota limits, and hundred of other ideas about running a

Figure 3.1

Investment and savings in Mauritius



modern garment assembly operation, such as knowledge of the sequence to use in sewing a shirt.

Hence, the EPZ constituted a politically astute strategy of partial opening up. It created a productive outlet for a domestic savings boom, and enabled the importation of ideas about modern production and marketing.

Investment policies in East Asia²³

It is now well-recognized that East Asia's phenomenal growth has been driven by physical investment. Table 3.1 shows a recent decomposition of the sources of growth for three East Asian countries, South Korea, Taiwan, and Singapore. In all three countries, the accumulation of physical capital is the most significant proximate determinant of growth. In South Korea, for example, 3.3 percentage points of the 5.7 percent growth in output per worker (or 58 percent) is accounted for by physical investment, with only 1.5 percentage points (26 percent) accounted for by TFP growth. Understanding East Asia's growth requires understanding the reasons for the investment boom.

Export-led growth?

The standard story about East Asia is one of export-led growth. During the 1950s, the conventional account goes, South Korea and Taiwan engaged in traditional import-substitution policies, with multiple exchange rates, high levels of trade protection, and repressed financial markets. By the late 1950s, each country had exhausted the "easy stage" of import substitution. This, together with the impending reduction of U.S. aid—which had been the main source of

Table 3.1

Sources of Growth in East Asian Countries, 1960-94
(annual averages, percent)

	growth of output	contribution of		
	per worker	physical capital	education	TFP
South Korea	5.7	3.3	0.8	1.5
Taiwan	5.8	3.1	0.6	2.0
Singapore	5.4	3.4	0.4	1.5

Source: Collins and Bosworth (1996).

foreign exchange for both economies—led policy makers in the two countries to alter their economic strategy and adopt export-oriented policies. These policies included the unification of exchange rates accompanied by devaluations, various other measures to stimulate exports (including most significantly duty-free access for exporters to imported inputs), higher interest rates, and some liberalization of the import regime. As a consequence of these measures, as well as a broadly supportive policy environment (encompassing macroeconomic stability and public investment in infrastructure and in human capital), exports took off in the mid-1960s. Export orientation led both economies to specialize according to comparative advantage, resulting in rising incomes, investment, savings, and productivity.

This orthodox account has been criticized for downplaying the active role taken by the Taiwanese and South Korean governments in shaping the allocation of resources. Observers like Amsden (1989) and Wade (1990) have argued that the reforms of the 1960s went considerably beyond giving markets and comparative advantage free rein. According to these authors, governments in both countries had clear industrial priorities and they did not hesitate to intervene (through subsidies, trade restrictions, administrative guidance, public enterprises, or credit allocation) to reshape comparative advantage in the desired direction. Interestingly, however, the orthodox and revisionist accounts converge on the importance of the export-oriented strategy in having disciplined firms and enhanced productivity growth. The World Bank's study, The East Asian Miracle (1993), has attempted to incorporate some of the revisionist objections (particularly on the role of directed credit) into the standard account.

Upon closer look, however, one discovers problems with the conventional story (Rodrik 1995c). First, the switch in relative incentives towards exports in the early 1960s was not

²³ The account of East Asia draws on Rodrik (1995c, 1997, 1998 forthcoming b).

significant enough to account for the export boom. Countries that have experienced sustained export growth outside of East Asia have almost always done so as a consequence of a sharp increase in the relative profitability of exports. What is striking about the experience of South Korea and Taiwan is how stable the relative price of their exportables was around the time of export take-off. In both countries, most of the important export incentives had already been in place for several years before the export boom started. Once the boom got under way, it picked up speed even though the measured profitability of exports did not increase further. Moreover, exports continued their inexorable rise often in the context of deteriorating incentives for exporting activities.²⁴

Second, it is not clear why export orientation (or the increase in exports) should have led to an investment boom. There are many cases in which even more sizable increases in the profitability of exports have either not led to increases in investment or have done so only after a considerable lag. This is important insofar as exports (unlike investment) do not directly lead to economic growth.

Consider two important examples. Turkey and Chile. In Turkey, there was a massive increase in the profitability of exports in the early 1980s of the order of more than 50 percent, with considerable import liberalization as well. These reforms were accompanied by an impressive increase in the export-GDP ratio. Yet private investment actually fell in this period, and did not recover until the second half of the 1980s. In Chile, an investment boom accompanied a fall in the relative profitability of exports in the late 1970s. Investment eventually collapsed in 1982-83 as a result of a major financial crisis. Export incentives increased significantly after 1982, but private investment responded sluggishly until 1989.

²⁴ These points are discussed at greater length in Rodrik (1995c). The evidence underlying the claims on the stability and timing of price incentives affecting exports comes from Frank et al. (1975).

It should not be surprising that export incentives and investment can co-vary in different ways. In theory, there is no reason to suppose that export orientation should be associated with an increase in investment demand. Export orientation makes some sectors more profitable and others (import-competing activities and non-tradables) less so. The same is true of import liberalization. The net effect on investment demand is indeterminate. If anything, the logic of relative factor endowments and the Stolper-Samuelson theorem yields an opposing presumption: In capital-poor countries like Taiwan and South Korea during the 1950s and 1960s, an increase in the relative price of exports should have been associated with a decline in the return to capital and hence reduced investment.

Third, since the export base in East Asia was typically quite small early on, the contribution of exports to GDP growth could not have been very high until at least the mid-1970s. In a fully-employed small open economy with marginal products of productive factors equalized among different activities, an increase in exports cannot, in any case, raise output. During much of the 1960s, Korea and Taiwan had some unemployment, as well as a productivity gap between the modern and traditional sectors of their economies. Under such conditions, an increase in exports can be expansionary, but the question is by how much? Exports were less than five percent of GDP in Korea around 1960, and barely over ten percent in Taiwan. In a purely accounting sense, exports could not have been responsible for more than a small fraction of the initial growth spurt in both countries, in view of the small base that they constituted.

Fourth, it is not clear that export growth was, or should have been, associated with cumulative productivity spillovers to the rest of the economy. There is a common presumption that the contribution of exports to growth came not from the demand side or through investment, but from widespread technological spillovers and cumulative productivity benefits deriving from

export performance. The World Bank's (1993) East Asian report gives this explanation top billing in its exposition of the "dynamic" benefits of outward orientation. However, as I discussed in the previous chapter, there is virtually no credible evidence that exports or outward orientation are generally associated with technological externalities.

In both Korea and Taiwan, manufactured exports accounted for a quarter or less of total exports around 1960, and consequently, they constituted a tiny share of national income. It is not easy to see how the spillovers from such a minuscule source, to the extent that they existed at all, could have been so strong as to set a process of aggregate economic growth into motion. Note, moreover, that overall productivity growth in manufacturing industry has not been spectacular in either country, and can explain only a small part of total growth.

Investment incentives

Korea and Taiwan

One of the most important changes that took place in the late 1950s in Taiwan and the early 1960s in Korea was a substantial transformation in government priorities. During much of the 1950s, economic goals had not ranked particularly high with either the Taiwanese or Korean leaderships. In Taiwan, the government was preoccupied with the re-conquest of the mainland. In Korea, Syngman Rhee's attention was focused on national consolidation and on political goals. By the end of the 1950s in Taiwan and the early 1960s in Korea, economic growth became a top priority of the leadership in both countries.

In Taiwan, an important turning point was the Nineteen-Point Reform Program instituted in 1960. This contained a wide range of subsidies for investment, and signaled a major shift in

government attitudes towards investment. As Lin (1973, 96) puts it, "[with] the announcement of the nineteen-point reform program of 1960, the improvement of investment climate became a catchword. The simplification of administrative procedures and the liberalization of regulative measures with regard to economic matters became an official goal." And in Korea, President Park, who took power in a military coup in 1961, could not have been more different from his predecessors. Park gave precedence to economics over politics, and to economic growth over other economic concerns, which was reflected in the amount of time he spent supporting growth-oriented bureaucrats and businessmen (see Jones and Sakong 1980, 40-43). Early on in his rule, Park made very clear that entrepreneurs who undertook investments in line with his priorities would be richly rewarded (while others would be penalized). Hence, in both countries there was a sharp change in the investment climate.

In addition to eliminating obstacles to investment, government policy subsidized investment highly. In Korea, the chief form of investment subsidy was the extension of credit to large business groups at negative real interest rates. Korean banks were nationalized after the military coup of 1961, and consequently the government obtained exclusive control over the allocation of investible funds in the economy. According to Jones and Sakong (1980, 104), "the general bank [lending] rate has typically been half of the curb-market rate; and second, the real bank rate has often been negative and generally below even the most conservative estimates of the opportunity cost of capital." Another important manner in which investment was subsidized in Korea was through the socialization of investment risk in selected sectors. This emerged because the government—most notably President Park himself—provided an implicit guarantee that the state would bail out entrepreneurs investing in "desirable" activities if circumstances later threatened the profitability of those investments.

In Taiwan, investment subsidies took different forms. Real lending rates were generally positive and credit subsidies were much less important. The most important direct subsidies in Taiwan came in the form of tax incentives. The Statute for Encouragement of Investment (enacted in 1960 in conjunction with the Nineteen-Point program mentioned above) represented a "sweeping extension" (Lin 1973, 85) of the prevailing tax credit system for investment. The maximum business income tax paid by enterprises was reduced to 18 percent of annual income (from a previous maximum of 32.5 percent); the tax holiday for new investments was extended from three to five years; tax exemption was given to undistributed dividends for reinvestment and proceeds of export sales; the stamp tax and deed tax on "productive" real estate were made either tax exempt or taxable at reduced rates; payments of import duties on plant equipment were made deferrable, and payable in installments after starting operations. These incentives were further expanded in 1965, at which time the business income tax was reduced in all priority sectors listed in the investment law, and specified manufacturing sectors (in basic metals, electrical machinery and electronics, machinery, transportation equipment, chemical fertilizers, petrochemicals, and natural gas pipe) were given complete exemption from import duties on plant equipment.²⁵

In addition to providing subsidies, the Korean and Taiwanese governments played a much more direct, hands-on role by organizing private entrepreneurs into investments that they may not have otherwise made. In both cases, we have good case histories of how the government actively took steps to ensure that private entrepreneurs would invest in certain areas. In Taiwan, it was the government that took the initial steps in establishing such industries as plastics, textiles, fibers, steel, and electronics. In Korea, in the words of Amsden (1989, 80-81),

²⁵ The information in this paragraph is taken from Lin (1973, 85-87) and Kuo (1983, 301).

"[t]he initiative to enter new manufacturing branches has come primarily from the public sphere. Ignoring the 1950s, ...every major shift in industrial diversification in the decades of the 1960s and 1970s was instigated by the state..."

Finally, public enterprises played a very important role in enhancing the profitability of private investment in both countries (perhaps more so in Taiwan than in Korea), by ensuring that key inputs were available locally for private producers downstream. In Taiwan, it was common for the state to establish new upstream industries and then either hand the factories over to selected private entrepreneurs (as in the case of glass, plastics, steel, and cement) or run them as public enterprises (Wade 1990, 78). In Korea, the government established many new public enterprises in the 1960s and 1970s, particularly in basic industries characterized by high degree of linkages and scale economies (Jones and Sakong 1980). In both countries, public enterprises were the recipient of favorable credit terms, as well as direct allocations from the government budget. Not only did public enterprises account for a large share of manufacturing output and investment in each country, their importance actually increased during the critical take-off years of the 1960s.

Singapore

Investment was heavily subsidized in Singapore as well. The year 1968 marked a dramatic expansion of the Singaporean government's involvement in investment activities, with the Development Bank of Singapore (DBS) increasing its financial commitments eight-fold over a two-and-a-half year period (Young 1992, 21). A substantial share of the economy came to be owned, directly or indirectly, by the Singaporean government as a result. These huge investments were funded by surpluses on the current account of the government budget, as well as by borrowing from the Central Provident Fund (Young 1992).

Unlike Korea and Taiwan, Singapore focused its incentives heavily on foreign investors. According to Young (1992), 1968 marked a turning point with regard to foreign investment as well. Labor legislation passed that year significantly strengthened management's bargaining power over issues of pay, benefits, and other working conditions. A wide range of tax incentives for investors were phased in or expanded after 1967, with exemptions from profits taxes taking the lead. While in principle these incentives did not discriminate between domestic and foreign investors, "because they are usually linked to sizable investments involving advanced technologies in new (targeted) industries, the overwhelming majority of participants are foreign" (Young 1992, 23).

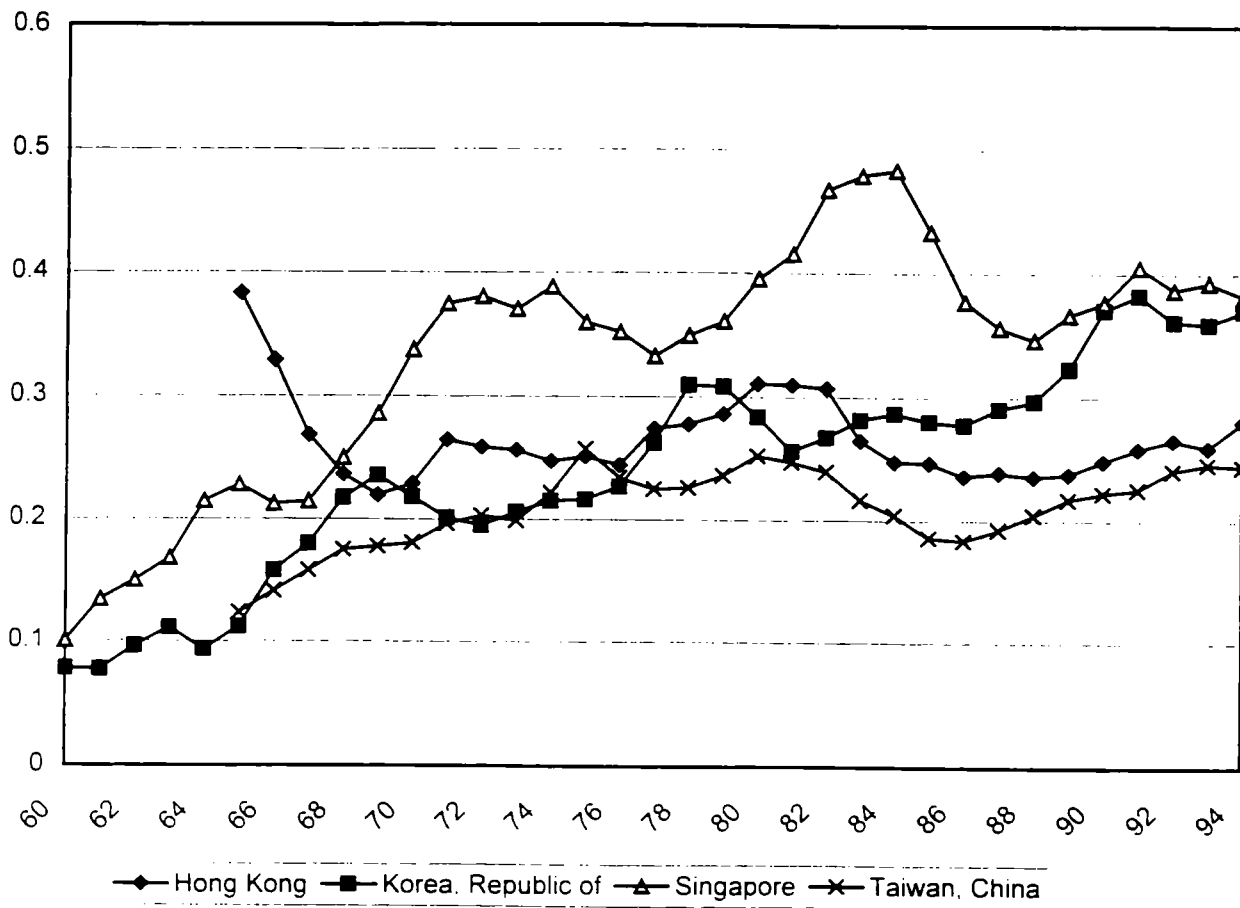
Young emphasizes that Singapore's Pioneer Industries Ordinance, the source of the most significant tax holidays provided to foreign investors, dates from 1959. He notes that the Ordinance failed to attract much foreign investment "until after 1968, when the Singaporean government began to expand its own financial participation in manufacturing and other sectors" (1992, 24). He suggests that after that date the government subsidized foreign investment beyond the tax incentives themselves, at quite exorbitant rates.

Discussion

In economies with complete markets, investment subsidies of the kind just discussed will reduce real income, even if they end up increasing investment. However, this hardly applies to Taiwan, Korea, or Singapore in the 1960s. The more realistic presumption is that a range of market failures kept investment below what would have been socially optimal. I have argued elsewhere (Rodrik 1996a) that there is a *prima facie* case for the existence of coordination failures in private-sector investment decisions in economies like Korea's, Taiwan's and Singapore's. This accounts for why large-scale investments would turn out to be privately (and

Figure 3.2

**Fixed investment-GDP ratios in East Asia
(at 1987 prices)**



socially) profitable while individual investments were perceived as not being profitable in the absence of government inducements. One way of viewing investment subsidies in these economies, then, is as policies that alleviated such coordination failures.

What about Hong Kong?

Alwyn Young's (1992) well-known essay on Singapore and Hong Kong, on which I have drawn above, argued that the former government's aggressive pro-investment policies were largely to blame for what, to Young, appeared to be a poor aggregate TFP growth record in manufactures. In comparison, Hong Kong has been a paragon of free-markets, with a much better productivity performance.²⁶

At first blush, Hong-Kong's experience would appear to confirm that it is primarily (if not exclusively) "fundamentals" that matter, with industrial policies that stimulate investment playing either no role or a negative one. Indeed, Hong Kong is the standard counter-example to analyses that posit a useful role for activist government policies. However, this is a misreading of the evidence. By 1960, Hong Kong was already a relatively wealthy country, with a high investment rate and favorable growth prospects. Unlike the other three East Asian countries, Hong Kong did not face a fundamental developmental challenge. There was much less need for an investment strategy.

Figure 3.2 shows investment rates for the four East Asian countries since the 1960s. As the figure makes clear, Hong Kong was already a high-investment country by the mid-1960s, when the World Bank data start. In 1965, the first year for which the World Bank provides

²⁶ Young (1995) estimates TFP growth since the 1960s to have been 2.3 percent in Hong Kong and near zero (0.2 percent) in Singapore. The Collins-Bosworth estimate for Singapore is substantially higher (Table 1), although still undistinguished by comparative standards.

investment data for Hong Kong, the investment rate in Hong Kong was 38 percent, compared to eleven percent in Korea, 23 percent in Singapore, and twelve percent in Taiwan (all at 1987 relative-prices). According to the Penn World Tables, which does provide earlier figures for investment rates, the figure for 1960 is 24 percent for Hong Kong, compared to seven percent in Korea, eleven percent in Singapore, and 15 percent in Taiwan. Whichever source we use, it is clear that Hong Kong's investment rate was substantially higher by the early 1960s than in any of the other countries.

For historical reasons having to do with its entrepôt role in international trade, Hong Kong was already a relatively rich country in 1960, with a per capita income of 2,222 in 1985 dollars, a level which South Korea and Taiwan would not reach for at least another decade. Hong Kong's transition to high investment appears to have taken place largely during the 1950s, when the country was a haven of economic and political stability in the region. There were major inflows of capital from China and elsewhere. Hence, one can argue that Hong Kong did not face the central challenge of economic development—how to transform a low-saving, low-investment economy into a high-saving, high-investment one—in quite the same way that the other economies did.

Further, Hong Kong is the only country in the region that has not experienced a steady and sustained increase in investment (as a share of GDP) since the early 1960s (see Figure 3.2). This is also consistent with the absence of an explicit investment strategy: the government's non-interventionist stance is reflected in a flat investment ratio. Arguably, this has not been costly insofar as the Hong Kong economy had already reached a certain degree of maturity. The other countries of the region started from considerably lower levels, and needed their governments to give accumulation a push. Hong Kong's experience suggests that a hands-off attitude to

investment can succeed when investment is already comparatively high and the appropriate institutions are in place. At the same time, far from suggesting the irrelevance of interventionist policies, Hong Kong's experience confirms that a sustained rise in the domestic investment effort is unlikely to be achieved in the absence of government policies directed towards that aim.

Investment transitions

Countries that are able to engineer increases in their investment efforts experience faster economic growth. They also become more outward oriented, and witness a rising share of exports in GDP. Hence investment transitions produce richer economies that are more integrated with the world economy.

These statements are patently true for the handful of countries whose experiences I have so far described. But are they true in general? Since an investment-centered approach to economic development raises eyebrows nowadays, it is important to get the stylized facts straight.

In this section, I take a broader cut at analyzing the contours of investment transitions and present the results of a statistical exercise covering all developing countries for which I have data. The purpose is to identify "episodes" of investment transitions and to delineate their consequences by comparing trends in economic growth and exports before and after such transitions. For the purposes of this exercise, I define an investment transition as a sustained increase in the investment/GDP ratio of five percentage points or more. Specifically, a country is said to undergo an investment transition at year T if the three-year moving average of its investment rate over an eight-year period starting at $T+1$ exceeds the five-year average of its investment rate prior to T by five percentage points or more. I exclude major oil exporting

countries and the developed countries. I also exclude cases where the post-transition investment rate remains below ten percent. To maximize the available sample size, I use as the investment rate gross fixed capital investment as a share of GDP at current prices. All data come from the World Bank.

The exercise yields 47 episodes of investment transitions, listed in Table 3.2. The table shows the year of the transition for each country listed, as well as the investment rates before and after the transitions. The median investment rate for all the countries listed rises from 15 to 26 percent of GDP following the transition. The table contains the well-known cases I have already discussed: Korea (1965), Singapore (1965), and Mauritius (1971).²⁷ Many of the other instances are also familiar: Botswana (1966), Chile (1986), China (1970), Indonesia (1969), and Thailand (1966). But there are also others that would have easily escaped notice in the absence of a systematic search. The advantage of this approach is that we can make generalizations that go beyond the well-known, well-studied cases.

What happens to economic growth and to exports following investment transitions? The simplest way to analyze the average tendencies in the data is to re-order the annual data for each country according to "transition years." Take, for example, the case of Botswana, with transition year 1966. Setting $T=1966$, Botswana's growth rate for 1965 becomes its growth rate for $T-1$, its growth rate for 1967 becomes its growth rate for $T+1$, and so on. We then calculate the median values of the relevant indicator across countries for corresponding transition years. The trends in these median values can help us create a picture of the "typical" pattern.²⁸

²⁷ Taiwan does not show up because Taiwanese data start in 1965, and the filter I have applied requires five years of observations prior to a candidate transition year before a transition can be identified.

²⁸ This analysis is inspired by Fischer, Sahay, and Vegh (1996), who applied a similar framework to the study of stabilization in former socialist economies.

Figure 3.3 tells the story with respect to growth. It displays the median investment and growth rates for the sample of countries that have undergone investment transitions, with the country data ordered according to transition years as described above. The growth rates shown are relative to world averages, to eliminate the effect of global trends in growth, and they have been smoothed by taking a three-year moving average (centered on the year in question). As the figure shows, investment transitions are associated with significant increases in economic growth. The underlying data reveal that countries which experience an investment transition go from a growth rate which is 0.8 percentage points less than the world average to 1.4 percentage more than the average (with each average calculated for the five years pre- and post-transition). This is a difference of 2.2 percentage points, which is quite significant.

The figure also reveals that some of the growth gains are eventually reversed, even though investment remains high. This finding reflects the fact that many of the countries listed in Table 3.2 did a lousy job of handling the external shocks of the 1970s and later. I shall argue in the next chapter that this is the result of the poor quality of their institutions of conflict management. We note for now that, even after this decline, growth performance remains superior when compared to pre-transition rates. The average growth rate in years $[T+11, T+15]$ (once the change in world growth is taken out) is still 1.1 percentage points above the corresponding rate for years $[T-5, T-1]$.

The results with respect to export performance are shown in Figure 3.4. The figure reveals a steady and unmistakable increase in export/GDP ratios following on the heels of investment transitions. Prior to the first year of the transition, exports are flat, with the median value slightly less than 20 percent of GDP. This number increases to 22 percent in years $[T, T+4]$ and to 27 percent in years $[T+5, T+9]$, stabilizing thereafter. The cumulative effect of an

Figure 3.3

Investment transitions and growth

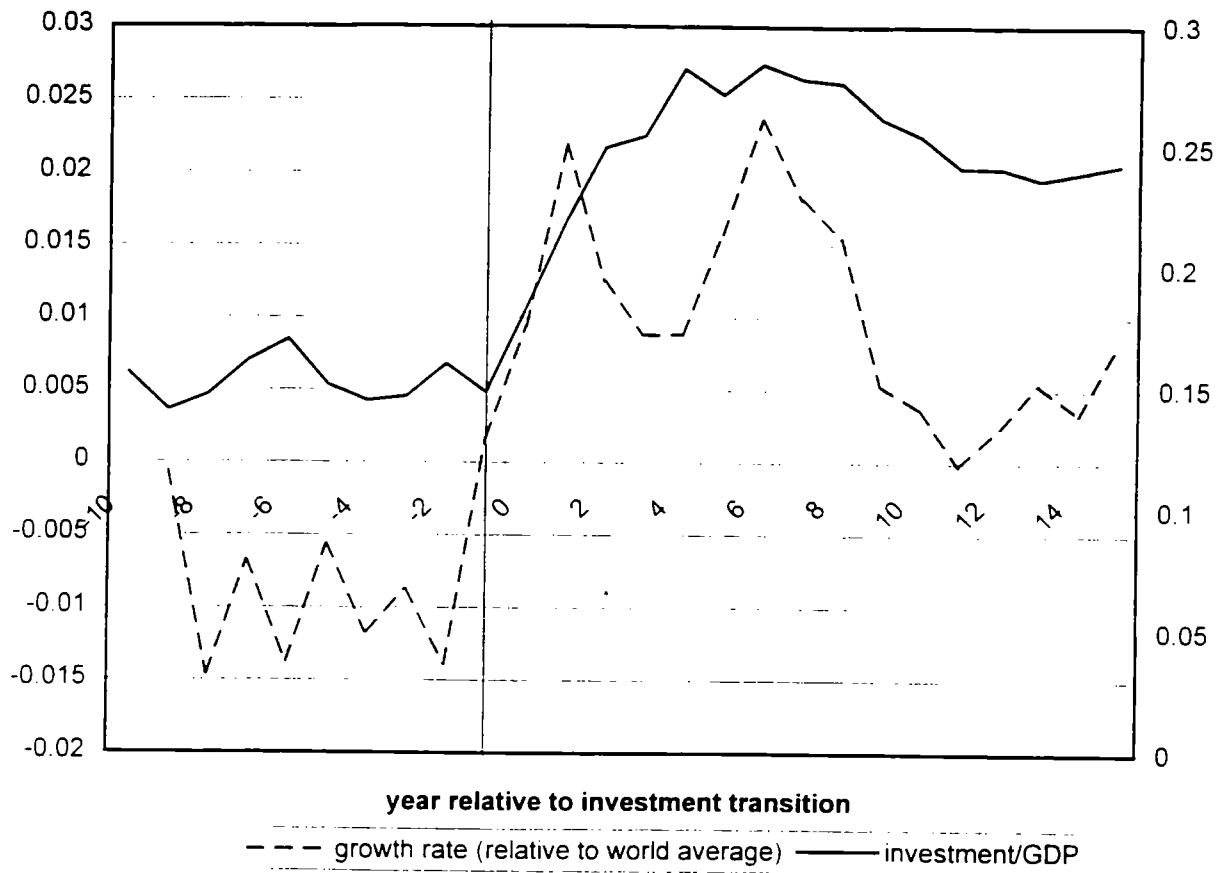
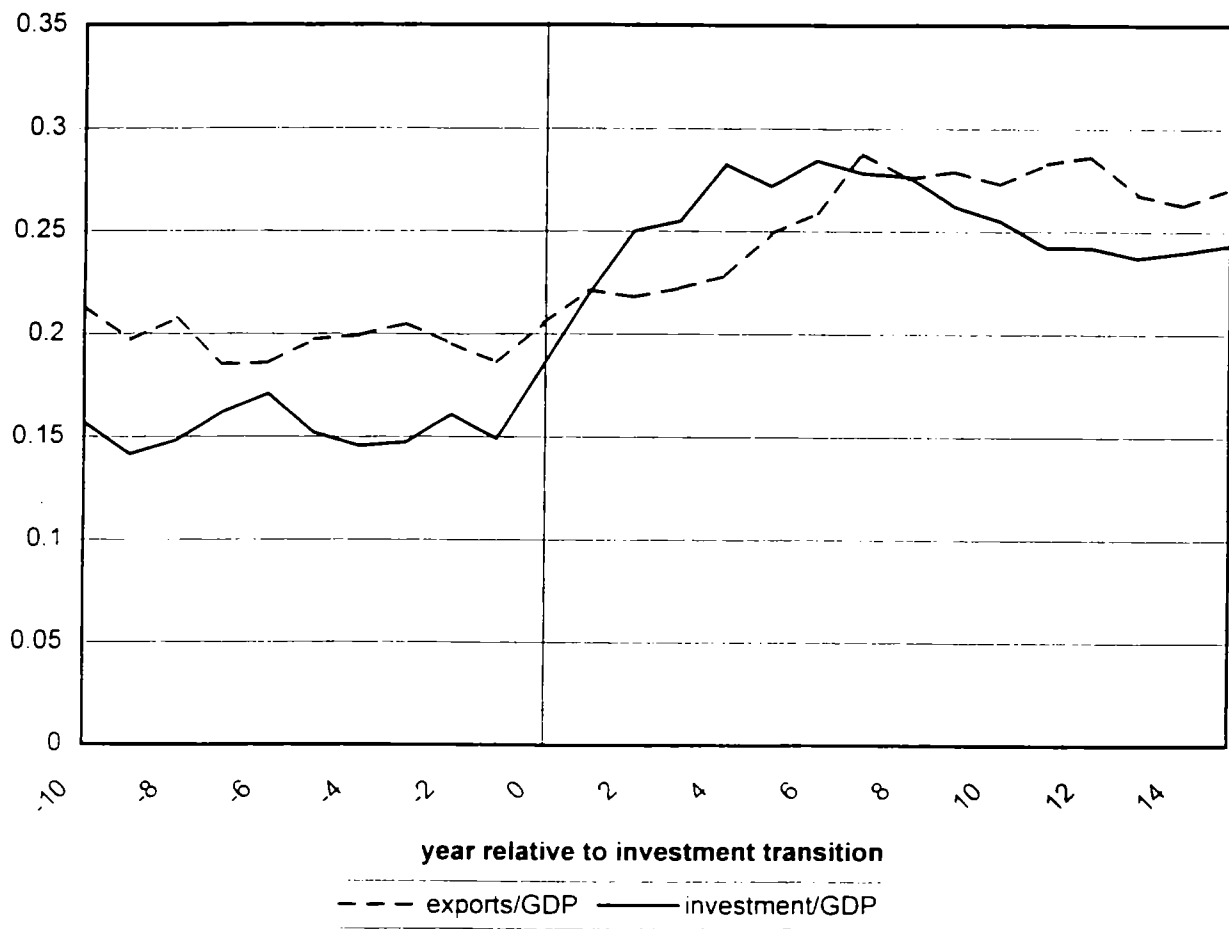


Figure 3.4

Investment transitions and exports



investment transition is a rise in the export-GDP ratio of more than 7 percentage points over a period of a decade. Hence, investment is good not only for growth, but for export performance as well.

Concluding remarks

The intellectual climate regarding physical investment has changed radically since the heyday of “capital fundamentalism” in the 1950s. So much so that one can pick up comprehensive reports on economic prospects for developing countries and not encounter a single word about the importance of investment—except for foreign investment, of course, which is typically judged to be critically important (e.g., World Bank 1997). Macroeconomic stability, free markets, and small government, it is asserted (or implied), is all that is necessary.

For countries with a well-established entrepreneurial class and an investment rate already at or above, say, 25 percent, this presumption may well be right. But for poorer countries with low levels of private investment and non-diversified production structures, more is likely to be needed. The lesson from East Asia is clear: the three East Asian dragons with low investment rates in the early 1960s—Korea, Taiwan, and Singapore—would not have been nearly as successful had their governments not given capital accumulation a big push by subsidizing, cajoling, and otherwise stimulating private investors. The evidence from East Asia and elsewhere shows that investment booms produce economic growth as well as greater export orientation. The evidence also implies that low levels of saving per se are not a significant obstacle to growth: household and corporate saving rates typically rise as profitable investment opportunities are exploited.

There is no hard and fast rule about what kind of strategy will work best in producing these investment transitions. The range of policies pursued differs greatly even among the East Asian countries. For example, compare the emphasis on subsidizing foreign investment in Singapore with the discouragement of DFI in Korea. A starting point is to remove policies—including trade restrictions—that keep the domestic price of investment goods high. Probably the most damaging aspect of trade restrictions in many Latin American and African countries has been their contribution to keeping the relative price of capital equipment high, and therefore investment rates low. Where investment subsidies are already in place, another important priority is to simplify the incentive regime so as to clarify objectives, provide transparent inducements, and reduce bureaucratic red tape.

Beyond these, much depends on the specific circumstances of the country and the imagination of policy makers. In general, smaller countries have fewer options, and must bear in mind that policies that orient investments exclusively to the home market will allow diminishing returns to capital accumulation to set in much more quickly. Sometimes luck, in the form of a terms-of-trade improvement or a resource discovery, will help. But, as in the Mauritian example of the early 1970s, good luck will have to be complemented with governmental efforts to channel resources into investments that diversify the economy.

Governments in countries with larger domestic markets can indulge in greater heterodoxy. Public investment—in infrastructure, irrigation, ports, and upstream industries—can often be a useful instrument for crowding in private investment, as the East Asian experience demonstrates. Experimentation with a certain dose of import-substitution policy in a few sectors of the economy may also prove productive, if it stimulates the animal spirits of domestic entrepreneurs. As I will argue in the next chapter, the import-substitution policies followed in

much of the developing world until the early 1980s were quite successful in some regards, and their costs have been greatly exaggerated.

I close this chapter with a clarification. My emphasis on the central role of investment should not be misunderstood as implying that all one needs to do to generate sustained growth is to raise the national investment effort. If that were the crux of the matter, centrally planned economies would have been the world's best performers over the longer run. Ultimately, the return to investment matters a great deal too. Rather, *the key is to induce the private sector to invest by enhancing the perceived returns to private investments, and to generate a virtuous cycle of profits, investments, and capacity expansion.*²⁹ In practice, different countries have found different ways of triggering this process: they have used direct investment subsidies (Korea and Taiwan), opened up profitable export opportunities (Mauritius), or provided a certain degree of protection in home markets (most countries with ISI policies). Successful cases are characterized neither by a hands-off approach with complete reliance on markets, nor by a strategy of command-and-control. They share a pragmatic approach built on the specific strengths of the domestic economy.

²⁹ This is the sense in which an economy's investment rate is endogenous, determined in turn by other variables including government policies. The short-run causality between investment and growth has not yet been fully sorted out in the literature. Blomstrom *et al.* (1996), for example, find that over five-year horizons investment tends to follow growth, rather than lead it. But such results are consistent with the argument in the text: policies (or other determinants) that enhance profitability will first show up in increased output.

Chapter 4: Managing Turbulence in the World Economy

Getting recent economic history straight

This chapter revolves around the recent economic history of the developing countries. I begin by emphasizing the successful nature of their experience with growth until the late 1970s, and then focus on the reasons for the dismal performance ever since. Much of current orthodoxy is based on a misleading interpretation of this history. Getting the story straight is important not only from an academic standpoint, but also as a guide to future policy. I will argue that what this history demonstrates is first and foremost the importance of maintaining macroeconomic stability in the face of a volatile external environment. Import-substitution policies themselves were not the root source of the decline in growth. Further, I will show that it is the quality of the domestic institutions of conflict management that determines a country's capacity for macroeconomic adjustment. This perspective has implications for a range of institutional reforms, ranging from the consolidation of democracy to the establishment of social insurance mechanisms.

The golden period of growth

The postwar period up until 1973 was the golden era for economic growth. Scores of developing countries experienced rates of economic expansion that were virtually unprecedented in the history of the world economy. As Table 4.1 shows, there were no fewer than 42 developing countries which grew at rates exceeding 2.5 percent per capita per annum until the first oil shock hit. At this rate of growth, incomes would double every 28 years or less—that is, every generation. The list of countries with this enviable record goes far beyond the handful of

Table 4.1

Per-capita GDP growth rates, by period
(countries ranked according to growth rate during 1960-73, percent)

<i>Country Name</i>	<i>Region</i>	<i>1960-73*</i>	<i>1973-84</i>	<i>1984-94</i>	<i>1960-94*</i>
Oman	MENA	10.52	5.22	0.83	5.96
Taiwan, China	EA&P	8.10	5.78	6.33	6.61
Singapore	EA&P	6.90	5.54	5.09	5.93
Swaziland	SSA	6.74	0.14	0.16	2.67
Korea, Republic of	EA&P	6.69	6.45	7.32	6.80
Hong Kong	EA&P	6.18	5.54	4.66	5.41
Botswana	SSA	6.15	7.34	4.11	5.94
Cote d'Ivoire	SSA	5.63	-0.20	-3.88	0.95
Malta	MENA	5.22	7.19	n.a.	5.74
Barbados	AMER	5.22	1.13	1.34	2.76
Israel	MENA	5.03	1.45	2.37	3.09
Lesotho	SSA	4.94	1.75	3.80	3.57
Brazil	AMER	4.74	1.72	0.81	2.60
Gabon	SSA	4.72	0.43	-4.20	0.71
Thailand	SA	4.49	3.93	7.21	5.10
Panama	AMER	4.46	1.74	0.44	2.40
Togo	SSA	4.17	-0.60	-2.42	0.69
Papua New Guinea	EA&P	4.14	-1.51	3.04	1.99
Malaysia	EA&P	4.09	4.50	3.87	4.16
Dominican Republic	AMER	3.77	1.66	1.05	2.29
Kenya	SSA	3.40	0.25	0.54	1.54
Fiji	EA&P	3.19	0.50	1.52	1.83
Mexico	AMER	3.18	2.05	0.43	2.01
Mauritius	SSA	3.14	0.96	5.22	3.24
Pakistan	SA	3.10	2.70	2.37	2.76
Costa Rica	AMER	3.02	0.15	1.84	1.74
Trinidad and Tobago	AMER	2.97	2.51	-2.45	1.23
Jamaica	AMER	2.97	-2.63	2.20	0.93
Burundi	SSA	2.95	0.86	-0.51	1.26
Turkey	MENA	2.94	1.67	1.87	2.21
Belize	AMER	2.91	2.37	3.80	3.00
Malawi	SSA	2.85	0.78	-1.98	0.76
Mauritania	SSA	2.85	-0.83	0.38	0.93
Bahamas, The	AMER	2.84	1.12	-0.47	1.31
Gambia, The	SSA	2.80	1.27	-1.33	1.09
Guatemala	AMER	2.79	0.03	0.10	1.11
Nicaragua	AMER	2.71	-3.06	-4.67	-1.33
Seychelles	SSA	2.67	2.34	4.09	2.98
Egypt, Arab Rep	MENA	2.64	6.05	0.33	3.06
Tanzania	SSA	2.64	-3.65	0.50	-0.03
Iraq	MENA	2.60	-0.93	n.a.	n.a.
Zimbabwe	SSA	2.58	-0.85	0.16	0.75
China	EA&P	2.48	5.39	8.52	5.20
Congo	SSA	2.46	5.75	-3.69	1.72
Colombia	AMER	2.45	1.68	2.37	2.18

Table 4.1

South Africa	SSA	2.39	0.19	-1.62	0.50
Argentina	AMER	2.29	-0.23	1.07	1.12
Peru	AMER	2.24	-0.66	-0.52	0.49
Bolivia	AMER	2.23	-0.70	0.32	0.72
Philippines	EA&P	2.10	1.13	-0.10	1.13

Note: *1965-1994 in some cases, where earlier data are not available.
Data for Mauritius are 1960-76 and 1976-84.

usual East Asian suspects, and covers all parts of the globe: it includes twelve countries in South America, six in the Middle East and North Africa, and even 15 in Sub-Saharan Africa. In fact, there were no less than six Sub-Saharan African countries among the 20 fastest-growing developing countries in the world prior to 1973: Swaziland, Botswana, Cote d'Ivoire, Lesotho, Gabon, and Togo, with Kenya ranking 21st. There were only ten countries in the developing world (for which we have data) where per-capita income failed to rise.³⁰

There can be little doubt that economic growth led to substantial improvements in the living conditions of the vast majority of the households in these countries. We can see the results in indicators of human development. Between 1967 and 1977, life expectancy at birth increased by four years in Brazil (from 58 to 62), by five years in Cote d'Ivoire (from 43 to 48), by five years in Mexico (from 60 to 65), and by five years in Pakistan (from 48 to 53). In Kenya, infant mortality fell from 112 (per 1,000 live births) in 1965 to 72 in 1980.³¹

Most of the countries that did well in this period followed import-substitution policies (ISI). These policies spurred growth and created protected and therefore profitable home markets for domestic entrepreneurs to invest in.³² Contrary to received wisdom, ISI-driven growth did not produce tremendous inefficiencies on an economy-wide scale. In fact, the productivity performance of many Latin American and Middle Eastern countries was, in comparative perspective, exemplary.

³⁰ Sub-Saharan African countries were disproportionately represented in this group, bringing down the region's average. The list of ten includes the following: Niger, Sudan, Chad, Bangladesh, Somalia, Rwanda, Haiti, Senegal, Madagascar, and Nepal. Note moreover that growth rates of GDP can be misleading indicators of increases in well-being if they are calculated at distorted domestic prices, which diverge from "shadow" prices. However, growth data from the Penn World Tables, calculated using international prices, are less susceptible to this problem and yield quite similar results. I use World Bank data here because these data cover a more recent period.

³¹ These figures come from the World Bank's World Data 1995 CD-ROM.

Table 4.2 shows averages for TFP growth for the three periods delineated in Table 4.1. As before, we look first only at the performance for the 1960-73 period. The comparative evidence is rather striking: Not only was average TFP growth during the period preceding the first oil shock quite high in the Middle East and Latin America (at 2.3 and 1.8 percent, respectively), it was actually significantly higher than in East Asia (1.3 percent)! Countries like Brazil, Dominican Republic, and Ecuador in Latin America, Iran, Morocco, and Tunisia in the Middle East, and Cote d'Ivoire and Kenya in Africa all experienced more rapid TFP growth than any of the East Asian countries in this early period (with the possible exception of Hong Kong, for which comparable data are not available). Mexico, Bolivia, Panama, Egypt, Algeria, Tanzania and Zaire experienced higher TFP growth than all but Taiwan. Of course, not all countries following ISI policies did well: Argentina is a striking counter-example, with an average TFP growth of only 0.2 percent during 1960-73.³³

Productivity growth estimates of this type are not without serious problems, and one can quibble with the methodologies employed (see Rodrik 1998b for a critique). Nevertheless, there is little reason to believe that the estimates of Collins and Bosworth (1996) shown in Table 4.2 are seriously biased in the way that they rank different regions. The inescapable conclusion is that most of the countries in Latin America and the Middle East had productivity-growth records prior to 1973 that look quite favorable in comparison with those in East Asia.

³² For an interesting political explanation, motivated by the Argentinean experience, for why many countries chose ISI policies see Robinson (1997). Robinson argues that in resource-rich countries like Argentina, open trade policies would have shifted power to agricultural interests, and was therefore blocked by capitalists.

³³ One possible explanation for Argentina's dismal performance prior to 1973 is that the kind of social conflicts that were exacerbated by the shocks of the 1970s in other countries (see discussion below) appeared much earlier in Argentina, with adverse effects on the quality of policy making. The deep cleavage between rural and urban interests in Argentina fostered wide swings in policy as well as highly restrictive trade policies (see O'Donnell 1979). I am grateful to Jim Robinson for the pointers on the Argentinean case and the reference to O'Donnell (1979).

Table 4.2

Economic performance by period (annual average growth rates, in percent)

	1960-73		1973-84		1984-94	
	GDP per worker	TFP	GDP per worker	TFP	GDP per worker	TFP
East Asia						
East Asia	4.2	1.3	4.0	0.5	4.4	1.6
Latin America	3.4	1.8	0.4	-1.1	0.1	-0.4
Middle East	4.7	2.3	0.5	-2.2	-1.1	-1.5
South Asia	1.8	0.1	2.5	1.2	2.7	1.5
Africa	1.9	0.3	-0.6	-2.0	-0.6	-0.4
East Asia						
China	2.2	1.4	4.3	2.2	8.0	4.6
Indonesia	2.5	1.1	4.3	0.5	3.7	0.9
Korea	5.6	1.4	5.3	1.1	6.2	2.1
Malaysia	4.0	1.0	3.6	0.4	3.8	1.4
Philippines	2.5	0.7	1.2	-1.3	-0.3	-0.9
Singapore	5.9	0.9	4.3	1.0	6.0	3.1
Thailand	4.8	1.4	3.6	1.1	6.9	3.3
Taiwan	6.8	2.2	4.9	0.9	5.6	2.8
Latin America						
Argentina	2.6	0.2	0.4	-1.0	1.1	1.0
Bolivia	3.5	2.1	-0.6	-1.5	-0.1	0.8
Brazil	4.4	2.9	1.0	-0.8	0.5	-0.2
Chile	1.6	0.7	-0.6	-0.7	4.7	3.7
Colombia	2.9	1.9	1.2	0.0	1.8	1.0
Costa Rica	2.8	1.2	-0.5	-2.0	1.9	0.6
Dominican Rep.	4.6	2.5	0.8	-1.3	0.0	-1.0
Ecuador	4.4	3.3	1.7	-0.5	0.0	-0.1
Guatemala	3.2	1.9	0.5	-0.9	0.0	0.2
Guyana	0.4	0.2	-4.6	-4.3	-0.5	-0.3
Honduras	2.4	1.3	0.3	-1.1	-0.6	-1.2
Haiti	-0.2	-0.8	1.1	-1.5	-5.2	-5.2
Jamaica	3.3	1.5	-4.4	-4.0	0.6	0.8
Mexico	3.8	1.6	0.7	-0.8	-1.1	-1.8
Nicaragua	3.1	1.4	-3.2	-4.1	-5.7	-5.5
Panama	4.6	1.7	1.4	-0.2	-0.3	-0.6
Peru	2.6	1.4	-1.1	-2.2	-1.5	-1.3
Paraguay	2.0	0.8	3.1	0.0	0.6	-0.3
El Salvador	2.0	0.6	-2.4	-3.6	-0.2	-0.2
Trinidad & Tobago	3.3	2.0	3.9	1.2	-3.3	-2.8
Uruguay	0.4	0.1	0.5	-0.9	2.8	2.5
Venezuela	1.2	0.9	-3.1	-4.3	-0.6	-0.4
Middle East						
Cyprus	3.9	1.4	5.6	4.0	4.8	3.5
Algeria	2.3	1.6	2.4	-0.1	-3.3	-3.3
Egypt	3.0	1.8	6.2	2.3	0.0	-1.5
Iran	6.1	2.4	-2.9	-5.7	-2.2	-2.2
Israel	5.1	3.3	1.2	-0.1	2.7	1.9

Table 4.2

Jordan	2.1	-0.9	6.7	2.3	-1.2	-2.9
Morocco	4.7	3.5	1.3	-0.5	0.9	0.3
Malta	3.7	1.9	6.6	4.9	3.9	2.0
Tunisia	4.1	2.3	2.2	0.2	0.7	0.1
South Asia						
Bangladesh	0.0	-0.6	2.5	1.8	1.1	0.7
India	1.8	0.1	2.4	1.0	3.1	1.6
Sri Lanka	2.1	1.0	3.2	0.7	2.7	1.0
Myanmar	0.5	0.1	3.5	1.9	-0.6	-1.6
Pakistan	3.9	0.2	2.8	2.0	2.7	1.5
Sub-Saharan Africa						
Cote D'Ivoire	5.9	3.3	0.5	-2.0	-2.4	-1.8
Cameroon	0.6	-0.8	6.7	3.4	-4.5	-5.7
Ethiopia	2.2	0.2	0.0	-0.9	-0.2	-1.6
Ghana	0.9	-1.0	-3.2	-3.2	1.8	1.1
Kenya	3.4	3.4	0.4	-0.1	0.1	0.4
Madagascar	0.3	-0.4	-2.0	-2.2	-0.9	-1.0
Mali	1.2	0.4	0.3	-0.2	0.9	0.4
Mozambique	2.9	1.1	-7.7	-7.1	3.5	3.0
Mauritius	1.5	1.5	1.0	0.3	4.0	2.8
Malawi	3.3	0.2	1.5	0.0	-1.1	-0.8
Nigeria	1.2	-0.9	-2.3	-4.6	1.3	2.0
Rwanda	-0.2	-0.8	1.7	-0.1	-3.6	-4.3
Sudan	-1.4	-3.7	2.1	0.2	-0.7	-0.7
Senegal	-0.5	-0.6	0.0	-0.2	0.2	-0.2
Sierra Leone	3.4	1.3	0.9	0.2	-0.3	-0.2
Uganda	0.7	-0.3	-2.9	-3.0	1.3	1.1
Tanzania	3.0	2.2	-1.1	-1.7	1.0	0.6
S Africa	2.3	0.9	1.0	-0.3	-2.0	-1.8
Zaire	2.4	2.2	-2.2	-3.4	-5.2	-5.9
Zambia	1.0	0.2	-2.3	-1.9	-2.5	-1.1
Zimbabwe	2.9	2.7	-0.8	-1.3	0.2	0.4

Source: Collins and Bosworth (1996) and personal communication from Susan Collins.
I am grateful to Collins for making the individual country data available.

How do we square this evidence with the received wisdom that countries following the ISI strategy fell prey to myriad inefficiencies? The dismal reputation of ISI is due partly to the subsequent collapse experienced by many of its adherents in the 1980s, and partly to the influential studies of Little, Scott, Scitovsky (1970) and Balassa and associates (1971). I will discuss the collapse of the 1980s and its possible links to ISI in the next section. I say a few words about Little et al. and Balassa here.

What these two important studies did was to document in detail some of the static economic inefficiencies generated by high and extremely dispersed rates of effective protection (ERP) in the manufacturing sectors of the countries under study. The discovery of cases of negative value added at world prices—that is, cases where countries would have been better off by throwing away the inputs than by processing them as they did in highly protected plants—was a particular shocker. However, neither study claimed to show that countries which had followed “outward oriented” strategies had been systematically immune from the same kind of inefficiencies. In fact, the evidence can be read as suggesting that there was no such clear dividing line. For example, the figures provided by Little et al. (1970, 174-190) show Taiwan to have had a higher average ERP in manufacturing, as well as greater variation in ERPs, than Mexico long after Taiwan’s trade reforms were introduced. This is significant since we commonly think of these two countries as exemplars of two diametrically opposed styles of development. Moreover, the systematic evidence on TFP growth reviewed above belies the idea that ISI produced more dynamic inefficiency than “outward orientation.”³⁴

³⁴ The “discovery” during the Asian financial crisis that not all investment projects in the world’s most outward-oriented countries were models of efficiency is also of relevance here. Standard cost-benefit analysis, unable to pinpoint positive externalities with any degree of certainty, is likely to pass a negative judgement on key investments not only in fast-growing developing countries, but also in some early industrializers like the United States.

Hence, as a strategy of industrialization, intended to raise domestic investment and enhance productivity, import substitution apparently worked pretty well in a very broad range of countries until at least the mid-1970s. Warts and all, ISI achieved a more than respectable record. In terms of the discussion in the previous chapter, ISI was a successful “investment strategy.” Had the world come to an end in 1973, ISI would not have acquired its dismal reputation, nor would East Asia have deserved its “miracle” appellation.³⁵

Oil shocks and debt crises: The watershed years

History, however, continued past 1973, and a disaster befell the vast majority of the economies that had been doing well. Of the 42 countries with growth rates above 2.5 percent prior to 1973, fewer than a third (twelve) managed the same record over the next decade (see Table 4.1). The median growth rate for all developing countries fell from 2.6 percent in 1960-73 to 0.9 percent in 1973-84 and to 0.8 percent in 1984-94. The dispersion in performance across developing countries increased sharply, with the coefficient of variation for national growth rates increasing three-fold after 1973 (Table 4.3).

Perhaps nothing tells the story in as striking terms as the evidence on TFP growth. The Middle East and Latin America, which had led the developing world in TFP growth prior to 1973, not only fell behind, but actually experienced negative TFP growth on average thereafter (see Table 4.2). In Sub-Saharan Africa, where productivity growth had been undistinguished but still positive, TFP growth turned negative as well. As Table 4.2 shows, East Asia held its own, while South Asia actually improved its performance.

³⁵ For a more balanced appraisal of ISI than is common these days, see the useful account by Bruton (1998).

Table 4.3

**Summary statistics for growth rates of per-capita GDP
(all developing countries, percent)**

	<i>1960-73</i>	<i>1973-84</i>	<i>1984-94</i>	<i>1960-94</i>
mean	2.52	0.99	0.94	1.62
median	2.59	0.86	0.81	1.23
coefficient of variation				
across countries	0.91	2.89	3.12	1.26

Source: Calculated from World Bank data.

Was this the result of the “exhaustion” of import-substitution policies, whatever that term actually means? Instead, the common timing implicates the turbulence experienced in the world economy following 1973—the abandonment of the Bretton Woods system of fixed exchange rates, two major oil shocks, various other commodity boom-and-bust cycles, plus the Volcker interest-rate shock of the early 1980s. The fact that some of the most ardent followers of ISI policies in South Asia (India and Pakistan in particular) managed to either hold on to their growth rates after 1973 (Pakistan) or increase them (India) also suggests that more than just ISI was involved.

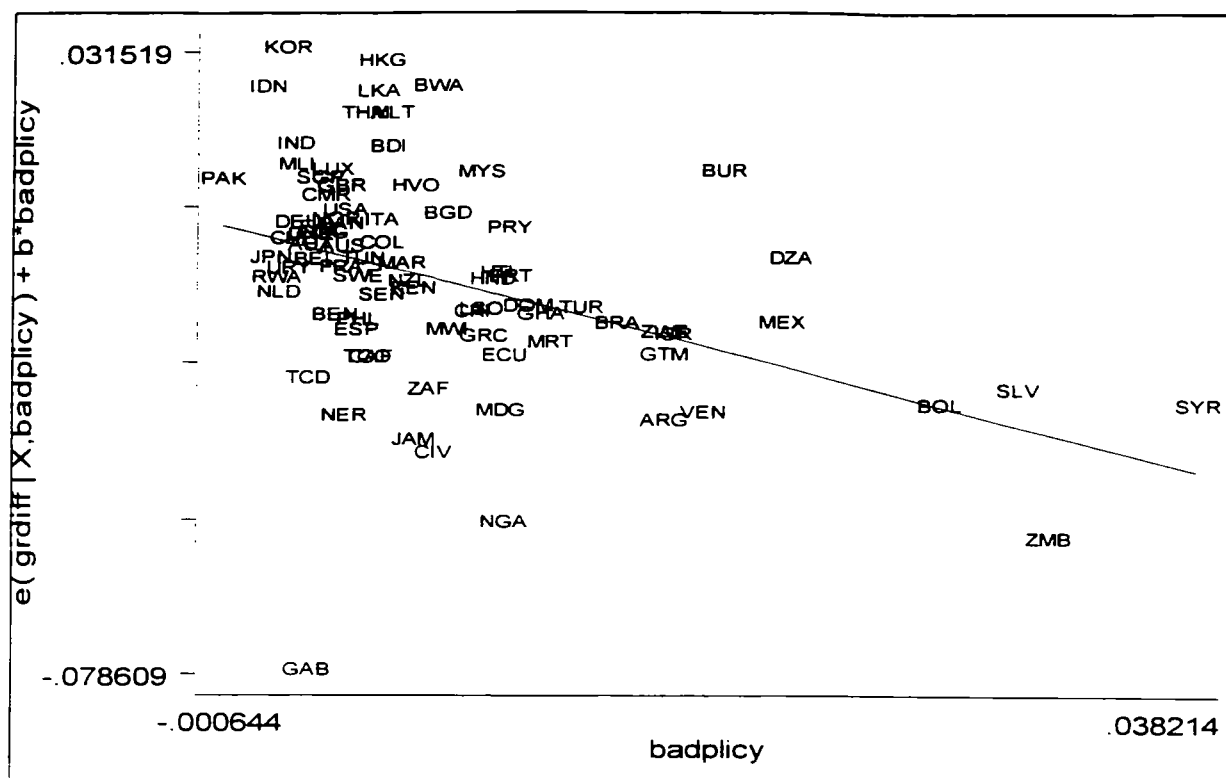
The actual story is straightforward. The proximate reason for the economic collapse was the inability to adjust macroeconomic policies appropriately in the wake of these external shocks. Macroeconomic maladjustment gave rise to a range of syndromes associated with macroeconomic instability—high or repressed inflation, scarcity of foreign exchange and large black-market premia, external payments imbalances and debt crises—which greatly magnified the real costs of the shocks. The evidence in Figure 4.1 demonstrates this point clearly. There was a strong association between inflation and black-market premia and the magnitude of economic collapse experienced in different countries. Countries that suffered the most were those with the largest increases in inflation and black-market premia for foreign currency. The culprits were poor monetary and fiscal policies and inadequate adjustments in exchange-rate policy, sometimes aggravated by shortsighted policies of creditors and the Bretton Woods institutions.³⁶

It is true that many, if not most, of the countries that had embarked on ISI strategies in the 1960s became the casualties of the debt crisis and related macro syndromes. This is what makes

³⁶ For a parallel argument stressing macroeconomic mismanagement and debt crises, and de-emphasizing the role of trade orientation, see Cohen (1997).

Figure 4.1

The relationship between macroeconomic instability and growth collapse after 1975



Notes: The vertical axis shows the (unexplained part of the) change in per-capita growth rates between 1960-75 and 1975-89, with a positive number indicating an increase after 1975. The variable "badplicity" shown on the horizontal axis is a composite indicator of macroeconomic instability, representing the sum of the increases in inflation rates and black-market premia between the same two periods.

the association between ISI strategies and growth collapses plausible and compelling on the face of it. But there are problems with this interpretation. There are no good arguments as to why a set of microeconomic policies, such as the ISI policies, should have been necessarily and systematically associated with macroeconomic disequilibrium, which is what the debt crisis represented (see the discussion in Rodrik 1996b). In any case, it is clear that there was nothing preordained about the debt crisis: some of the countries that adhered most rigidly to ISI policies—India being a chief example—were able to avoid protracted debt crises. Indeed, as Table 4.2 shows, the only region of the world that experienced a significant rise in TFPG after 1973 was, in fact, South Asia (i.e., Bangladesh, India, Burma (Myanmar), Pakistan, and Sri Lanka), which is not exactly the region that comes to mind when one mentions “outward orientation.”

The point is made somewhat more systematically in Table 4.4, taken from Rodrik (1996b) and based on information from Little et al. (1993) and Easterly (1993). The table evaluates the relevance of three types of potential explanations for whether a country succumbed to the 1982 debt crisis or not: (a) the magnitude of the external shock; (b) the adjustments in monetary and fiscal policies; and (c) the extent of microeconomic policy distortions. The results point unambiguously to macroeconomic policies as the chief culprit. All the countries that Little et al. (1993) classify as having been “troubled” are also classified as cases of “failure to adjust monetary and fiscal policy.” None of the “untroubled” countries are similarly classified. With regard to price distortions, these were on average no higher (in fact somewhat lower) in the “troubled” countries than in the “untroubled” countries. Likewise, there is no clear-cut pattern where external shocks are concerned.

Table 4.4

Determinants of the debt crisis, 1982

	Large external shock	Failure to adjust monetary and fiscal policy	Large microeconomic distortions
<i>troubled countries</i>			
Argentina	No	Yes	Yes
Brazil	Yes	Yes	No
Chile	Yes	Yes	Yes
Costa Rica	No	Yes	Yes
Cote d'Ivoire	Yes	Yes	No
Mexico	No	Yes	n.a.
Morocco	No	Yes	Yes
Nigeria	No	Yes	No
<i>moderately troubled countries</i>			
Colombia	No	Yes	Yes
Kenya	Yes	Yes	No
Sri Lanka	Yes	No	Yes
<i>untroubled countries</i>			
Cameroon	Yes	No	No
India	No	No	Yes
Indonesia	No	No	Yes
Korea	Yes	No	No
Pakistan	No	No	Yes
Thailand	Yes	No	n.a.
Turkey	No	No	n.a.

Source: Little et al. (1993), Table 4.4. except for the relative-price distortion index which is taken from Easterly (1993). The latter index is the variance of the log input prices (relative to US prices) across commodities. measured in 1980. "Yes" > 0.26.

The bottom line is that in those countries that experienced a debt crisis, the crisis was the product of monetary and fiscal policies that were incompatible with sustainable external balances: there was too little expenditure reducing and expenditure switching. Trade and industrial policies had very little to do with bringing on the crisis.

Where does the ability to adjust macro policies come from?

Why were some countries quicker to adjust their macroeconomic policies than others? The deeper determinants of growth performance after the 1970s are rooted in the ability of domestic institutions to manage the distributional conflicts triggered by the external shocks of the period.

Shocks, macro policies, and social conflicts

Think of an economy that is suddenly and unexpectedly confronted with a drop in the price of its main export (or a sudden reversal of capital flows). The textbook prescription for this economy is a combination of expenditure-switching and expenditure-reducing policies—i.e., a devaluation and fiscal retrenchment. But the precise manner in which these policy changes are administered can have significant distributional implications. Should the devaluation be accompanied by wage controls? Should import tariffs be raised? Should the fiscal retrenchment take place through spending cuts or tax increases? If spending is to be cut, which types of expenditures should bear the brunt of the cuts? Should interest rates be raised to rein in private spending as well?

In general, macroeconomic theory does not have a clear preference among the available options. But since each of the options has predictable distributional consequences, in practice much depends on the severity of the social conflicts that lie beneath the surface. If the appropriate adjustments can be undertaken without an outbreak of distributional conflict or upsetting prevailing social bargains, the shock can be managed with few long-lasting effects on the economy. If they cannot, the economy can be paralyzed for years as inadequate adjustment condemns the country to foreign exchange bottlenecks, import compression, debt crises, and bouts of high inflation. Furthermore, deep social divisions provide an incentive to governments to delay needed adjustments and take on excessive levels of foreign debt, in the expectation that other social groups can be made to pay for the eventual costs.

Consider for example the experiences of three countries, all of which were hit by sizable terms-of-trade shocks during the mid- to late 1970s: South Korea, Turkey, and Brazil. Among these three, Korea suffered the greatest external shock, since trade constitutes a much larger share of national income in Korea, and the income loss associated with a rise in the price of imported oil was correspondingly larger in Korea than in Brazil or Turkey. Yet Korea grew even faster after the mid-1970s, while Turkey and Brazil both experienced an economic collapse.

Korea

At one level, it is not a great mystery why these experiences differ. In addition to greater dependence on oil imports, Korea's troubles in 1980 were exacerbated by an unusually poor agricultural harvest, which alone accounted for a three percent decline in GDP (Maddison 1985). However, as soon as signs of a payments imbalance appeared, the South Korean government, with help from the IMF, undertook a textbook adjustment in 1980, consisting of three main parts.

First, in January 1980, the Korean government devalued the won by 17 percent. This devaluation, along with a new, more flexible exchange rate policy, led to an overall decline in the won of seven percent in real terms by the end of 1980 (Aghevli and Marquez-Ruarte 1985). Second, for the first half of 1980, the government tightened monetary policy, particularly credit policy, which caused the growth of both bank credit and broad money to decline sharply. (A rather acute recession prompted Korean authorities to relax credit policy in the latter half of 1980). Finally, the third part of Korea's adjustment came in the form of a program aimed at increasing energy efficiency in the economy: namely, making Korea's economy less dependent on importing oil. Attempting this was no small task, since in 1979, oil constituted 63 percent of Korea's domestic energy consumption. This was accomplished in part by raising the price of oil 230 percent and by changes in the exchange rate. In addition, the program included mandates for reduced electricity consumption by non-essential activities, such as elevators and air conditioners (Aghevli and Marquez-Ruarte 1985).

Korea experienced a reduction in GDP growth of five percent in 1980. But largely because these expenditure-reduction and expenditure-switching policies were implemented rapidly and decisively, the economy avoided a protracted crisis. Growth resumed soon thereafter.

Turkey

The Turkish response was quite different. A populist government reacted to the growing current-account deficit in the mid-1970s by going on an unsustainable external borrowing binge. Private-sector foreign borrowing was subsidized by providing blanket protection against foreign-exchange risk. Once foreign bank loans dried up in 1977-78 as a result of concerns about repayment capacity, fiscal and exchange-rate adjustments were delayed.

The result was that inflation rose and the economy went into a tailspin between 1978 and 1980. Some semblance of macroeconomic balance was restored in 1980, when Turgut Ozal implemented a stabilization package supported by the IMF. The program relied on large changes in key relative prices (the real exchange rate, real wages, and the rural-urban terms of trade), with huge distributional consequences. These relative-price changes had the effect of transferring income from farmers and workers to the public sector (see Celasun and Rodrik 1989). They were greatly facilitated by the fact that military rule during 1980-83 kept protest from popular sectors in check.

These distributional shifts have created a legacy of macroeconomic cycles in Turkey, with real wages going through periods of recovery followed by bust. Largely due to this legacy of instability, inflation has remained high since the early 1980s, and the Turkish economy has underperformed relative to its potential.

Brazil

In Brazil, widespread indexation prevented an adjustment in relative prices of the kind that eventually took place in Turkey. Even without formal indexation, strategic interaction among social groups resulting in wage-price rigidities appears to have made orthodox adjustment policies of demand restraint extremely costly in terms of output (Simonsen 1988). Consequently, fiscal and monetary restraint was tried only half-heartedly. The result was an alternation between various currency-reform plans and a succession of high-inflation plateaus.

Inflation jumped from 50 percent per year to 100 percent in 1979, and then to 200 percent in 1983, where it stayed until the implementation of the Cruzado Plan in February of 1986, which froze the new currency's value at 1000 units of the former currency. This first attempt lasted until the end of the year, after which inflation again exploded to 400 percent in 1987,

1,000 percent in 1988, and more than 2,000 percent in 1990. Each failed stabilization resulted in higher inflation rates than previously, until the real plan of 1994 finally brought price stability. Introduced by now-president, then Minister of Finance, Fernando Henrique Cardoso, the real plan avoided the drastic measures of the previous attempts, and instead focused on reducing prices by more or less pegging the real against the dollar, thereby reducing inflationary expectation.

Discussion

These country stories underscore the importance of the manner in which different societies react to external shocks. In Korea, adjustment was swift and somehow non-politicized. In Turkey, adjustment was delayed and when it eventually took place it was undertaken in a manner that imposed disproportionate costs on certain segments of society, undercutting the sustainability of macro balances in the longer run. In Brazil, strategic competition among different social groups gave prices a life of their own and rendered traditional remedies for excess demand costly and ineffective.

In short, social conflicts and their management—whether successful or not—played a key role in transmitting the effects of external shocks on to economic performance. I believe that this is a key insight into economic performance and the manner in which the global economy impinges on it. Societies that benefit most from integration into the world economy are those that have the complementary institutions at home that manage and contain the conflicts that economic interdependence can trigger.

Cross-national evidence

Societies with deep social cleavages and poor institutions of conflict management tend not to be very good at handling shocks. In such societies, the economic costs of exogenous shocks—such as deteriorations in the terms of trade—are magnified by the distributional conflicts that are triggered. Such conflicts diminish the productivity with which a society's resources are utilized in a number of ways: by delaying needed adjustments in fiscal policies and key relative prices (such as the real exchange rate or real wages) and by diverting activities away from the productive and entrepreneurial spheres. As in Rodrik (1998c), the central idea can be summarized heuristically by the following formula:

$$\Delta growth = - external\ shocks \times \frac{latent\ social\ conflict}{institutions\ of\ conflict\ management}$$

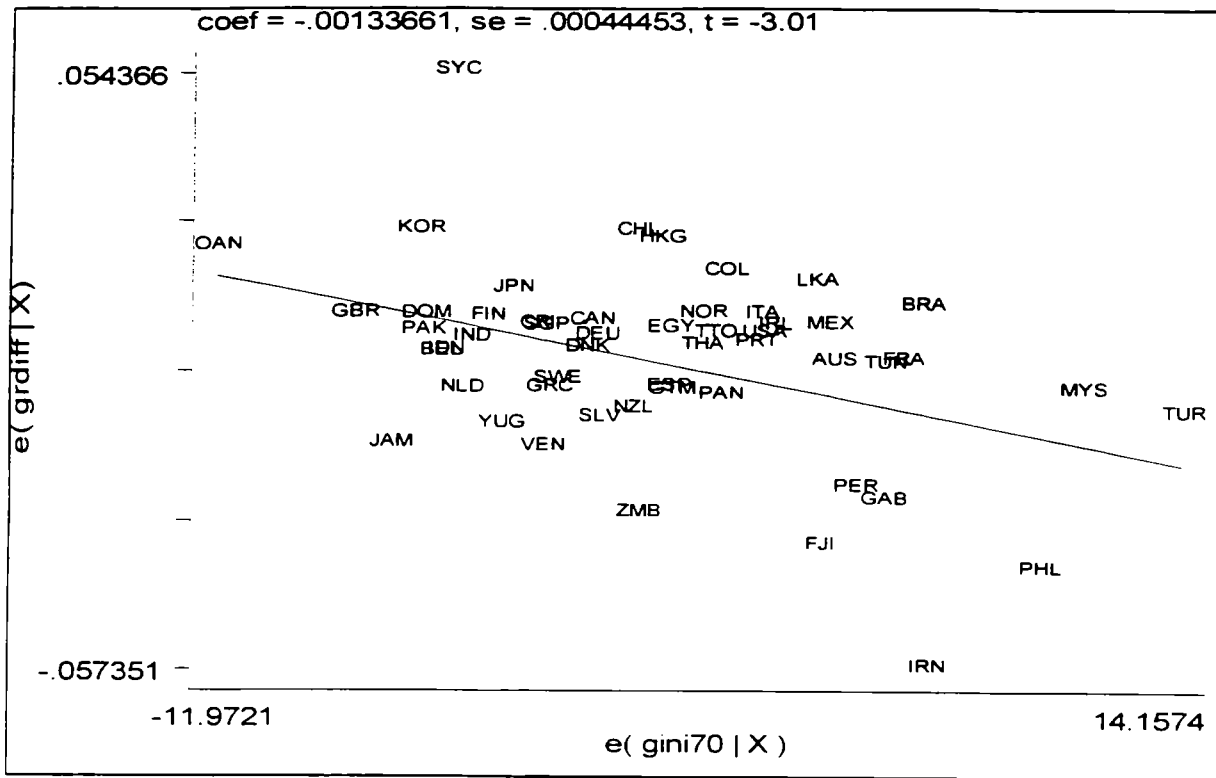
The effect of shocks on growth is larger the greater the latent social conflicts in an economy and the weaker its institutions of conflict management.

In the paper just mentioned, I used various proxies for the terms on the right-hand side of the equation to provide empirical support for the ideas. I measured external shocks by calculating the income effects of the volatility of the external terms of trade. I proxied for "latent social conflict" by using measures of inequality and ethnic and linguistic fragmentation. Most importantly, I proxied "institutions of conflict management" by using measures of democracy, the rule of law, and public spending on social insurance. I will provide an overview of some of the key results here.

Figures 4.2-4.6 display the partial correlations across countries between the reduction in growth after 1975 and various indicators of social conflict and institutions. In each case, the dependent variable (shown on the vertical axis) is the difference in per-capita growth rates

Figure 4.2

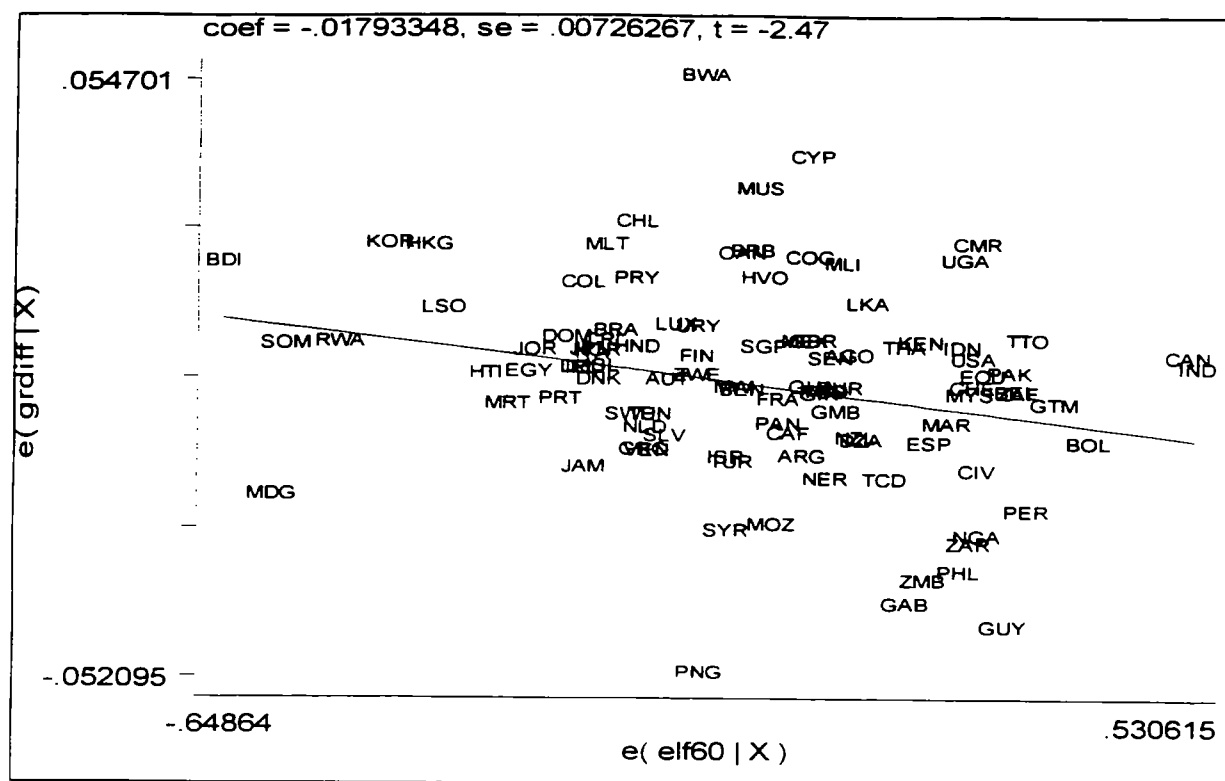
Countries with greater income inequality do worse in adjusting to shocks



Notes: The variable on the vertical axis is the (unexplained part of the) difference in growth rates between the two periods. The variable on the horizontal axis is the component of the relevant explanatory variable that is orthogonal to the other explanatory variables. The variable "gini70" is the Gini coefficient averaged for the years 1970-79.

Figure 4.3

Countries with greater ethnic and linguistic fragmentation also do worse



Notes: Same as Figure 4.2.

The variable "elf60" is the ethnolinguistic fragmentation index.

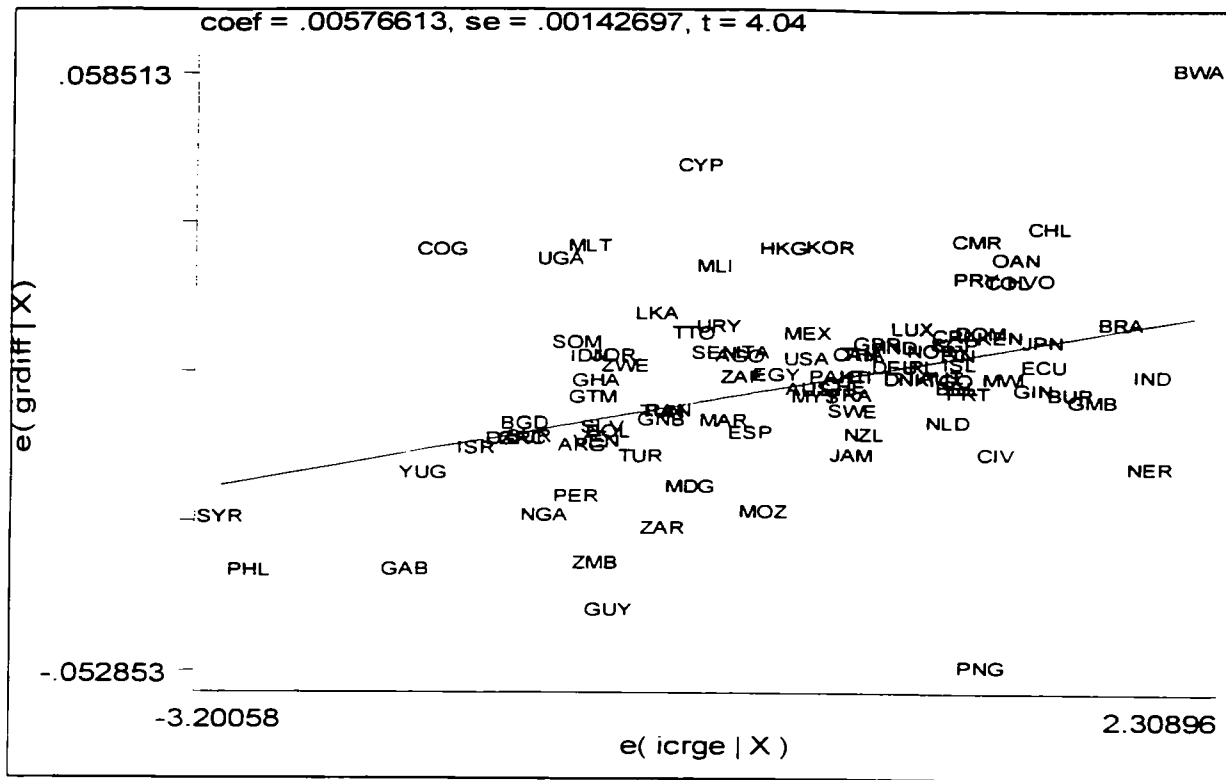
between the two periods 1960-75 and 1975-89. (A positive number indicates higher growth in the later period.) The following controls have been included in each regression, in addition to the variable of interest: growth in 1960-75 (to control for convergence), log per-capita GDP in 1975 (to control for other structural characteristics of economies that may be related to sensitivity to shocks), and regional dummies for Latin America, East Asia, and Sub-Saharan Africa (to rule out spurious correlation arising from purely geographical effects). Hence, the scatter plots represent the association between the variables on the axes after controlling for these other influences.

Figures 4.2 and 4.3 show that there is a strong statistical relationship between indicators of latent conflict and growth declines following external shocks. Countries with greater income inequalities during the 1970s (*gini70*) had larger reductions in economic growth. The estimated coefficient suggests that a ten point difference in the Gini scale (roughly the difference between Brazil and Costa Rica, or half the difference between Turkey and Taiwan) contributed a reduction in growth of 1.3 percentage points. The evidence on ethnic and linguistic fragmentation is similar (Figure 4.3). The indicator used here (*elf60*) comes from Mauro (1995) and measures the likelihood that any two randomly drawn individuals in a society will not belong to the same ethnic and linguistic group. There is a strong and statistically significant relationship between fragmentation according to this measure and the extent of growth collapse after 1975. Hence, countries with more divided societies—whether the divisions lie along income or ethnic lines—do a poor job of handling shocks.

The more encouraging results from the exercise relate to the role played by institutions, which are man-made and, in principle, can be improved. Figure 4.4 shows that the rule of law and the quality of governmental institutions make a significant difference, and can override latent

Figure 4.4

But rule of law and high-quality governmental institutions help



Notes: Same as Figure 4.2.

The variable "icrge" is the index of quality of governmental institutions.

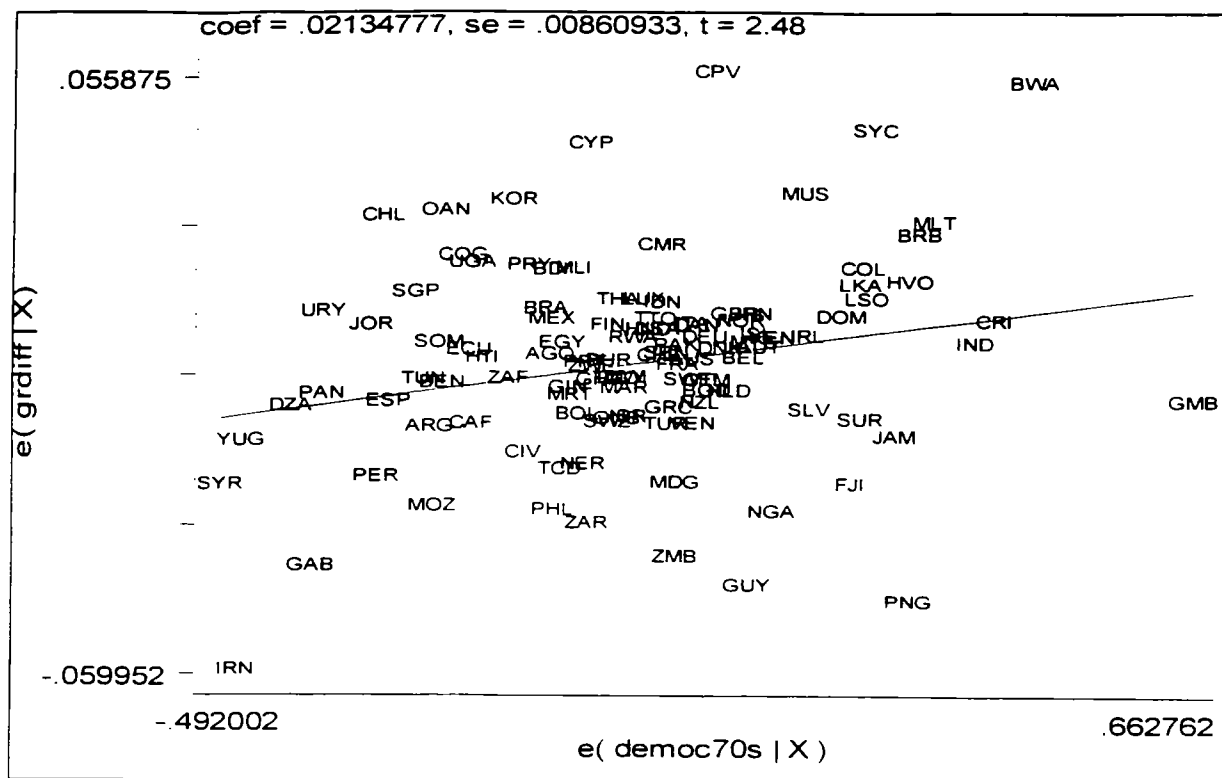
conflict and divisions. The indicator used in Figure 4.4 is Knack and Keefer's (1995) measure of institutional quality (*icrg*), which originates from the International Country Risk Guide. A one-point increase in this indicator (which is measured on a scale of one to ten) is estimated to increase growth (relative to the earlier period) by 0.6 percent.

Perhaps a more unexpected result is that democracy helps too (Figure 4.5). There is a strong association between various measures of democracy and relative economic performance since 1975. Figure 4.5 shows the results with the Freedom House indicator of civil liberties and political rights (*democ70s*, re-scaled from zero to one, with an increase corresponding to improvement in democratic rights). An increase in this indicator of 0.5 points during the 1970s (roughly the difference between Costa Rica and Mexico) is estimated to have increased post-1975 growth by one percentage point relative to earlier growth. This result holds across alternative data sets using different indicators of democratic procedures. Figure 4.6, for example, shows a similar exercise with an indicator that quantifies the degree of access by non-elites to political institutions during the second half of the 1970s (*parcom_x*, calibrated on a scale of zero to one, and taken from Jagers and Gurr 1995). I find that countries with more participatory political systems were generally better at handling the consequences of the shocks of the 1970s.

These kinds of results are not surprising once one looks at democracy from the perspective adopted here: democratic institutions are the institutions of conflict management par excellence. Democracy allows discredited policies and politicians to be discarded; it allows for institutionalized modes of participation instead of riots and protests; and it reduces incentives for non-cooperative behavior by making it harder for social groups to shift the burdens of adjustment

Figure 4.5

Civil liberties and political rights help too



Notes: Same as Figure 4.2.

The variable "democ70s" is the democracy index averaged over 1970-79.

Access by non-elites to political institutions enhances response to shocks



disproportionately on to others (Rodrik 1998c). I will discuss the role of democracy a bit more extensively below.

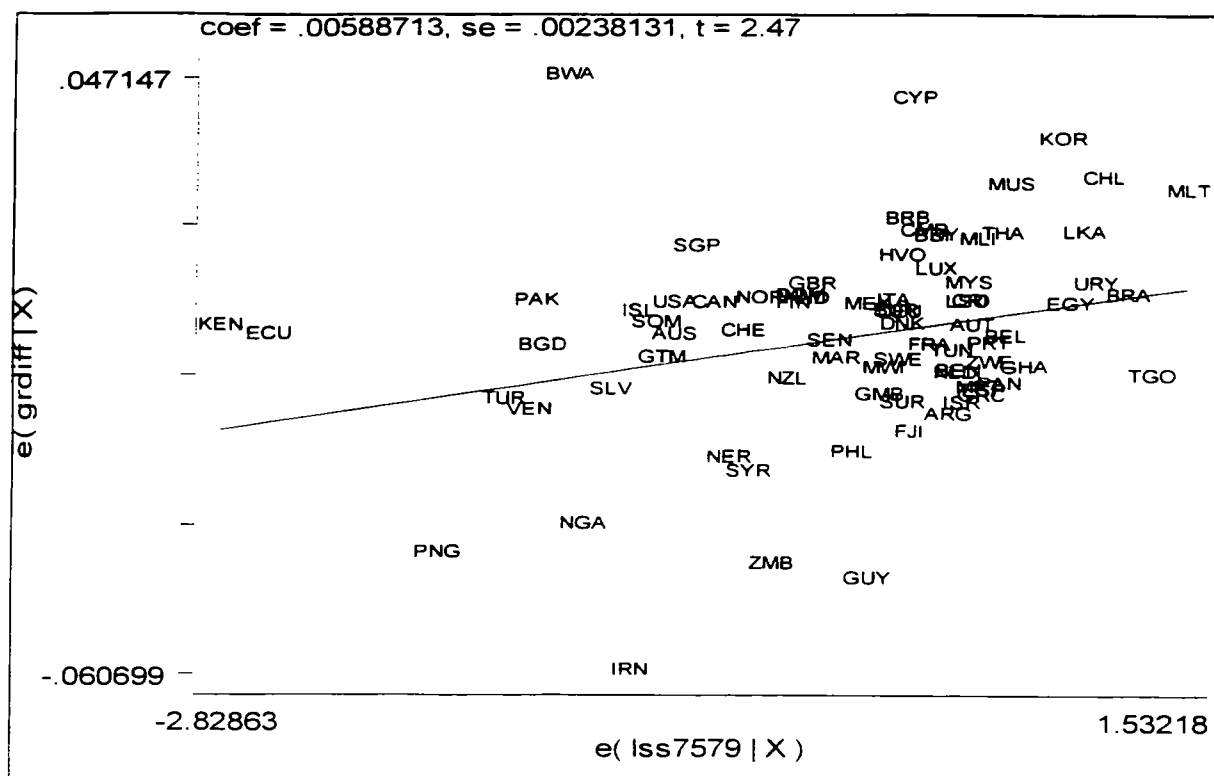
There is also some suggestive evidence that societies that provide their citizens with greater amounts of social insurance tend to be better positioned to deal with shocks. Comprehensive and comparable measures of social insurance are of course difficult to come by. In Figure 4.7, I use a crude indicator, the logarithm of government spending on social security and welfare as a share of GDP during 1975-79 (*lss7579*). The results are suggestive: there is a positive and statistically significant relationship between spending on social safety nets and relative performance after 1975. While more evidence is certainly needed, these results are supportive of the positive role played by social insurance in managing shocks and social conflict.

Finally, I show in Table 4.5 that the social-conflict indicators I have considered here tend to be strongly correlated with the incidence of macroeconomic disequilibrium after 1975. Towards this purpose, I have constructed an indicator of macroeconomic disequilibrium for each country, taking a linear combination of the increase in the inflation rates and black-market premia for foreign currency between the two periods. The weights on each component of the indicator are selected such that a unit increase in this indicator is associated with a one-percentage point decline in growth. This particular result is shown in column (1) of Table 4.5. Note that the estimated coefficient on macroeconomic disequilibrium is highly significant (with a t-statistic exceeding six), bearing out the argument made above regarding the critical role played by macroeconomic adjustment.

The remaining columns in Table 4.5 show that macroeconomic disequilibrium was more likely in countries with high degrees of income inequality and ethno-linguistic fragmentation, and less likely in countries with democratic institutions or high-quality governmental

Figure 4.7

Social insurance helps too



Notes: Same as Figure 4.2.

The variable "lss7579" is the log of government expenditures on social security and welfare (as a share of GDP) averaged over 1975-79.

Table 4.5

Determinants of macroeconomic disequilibrium

	<i>dependent variable</i>				
	<i>difference in growth between two periods</i>	<i>index of macro maladjustment</i>			
	(1)	(2)	(3)	(4)	(5)
<i>index of macro maladjustment</i>	-1.00 (0.16)				
<i>Gini coefficient, 1970s</i>		0.04* (0.01)			
<i>ELF60</i>			0.27 (0.28)		
<i>democracy (1970s)</i>				-0.99** (0.49)	
<i>institutions (ICRG)</i>					-0.33* (0.09)
N	79	42	82	79	72
R ²	0.63	0.71	0.16	0.36	0.48

Notes: Robust standard errors reported in parenthesis. Levels of statistical significance indicated by asterisks: *99 percent; **95 percent; ***90 percent. Additional explanatory variables not shown here: growth, 1960-75, log GDP per cap. 1975, a measure of external shocks, 1970s (except in col. 1), and regional dummies. "Index of macro maladjustment" represents a linear combination of the increase in rates of inflation and black-market premia over the two periods. Sample sizes differ according to the availability of data.

bureaucracies. All of these results are statistically significant at the 95-percent level or better, except in the case of *elf60*. These findings confirm the importance of the institutions of conflict management in maintaining macroeconomic stability.

The bottom line is that this broader perspective helps us understand the growth collapse that was the common fate of so many countries after the 1970s. Countries that experienced the sharpest drops in GDP growth after 1975 were those with divided societies and weak institutions of conflict management. Once latent social conflict and the quality of conflict-management institutions are taken into account, various measures of government policy at the outset of the crisis, such as openness to trade, microeconomic distortions, or the size of the public sector, contribute practically nothing to explaining economic performance after 1975 (relative to the earlier period: see Rodrik 1998c).

Shocks redux: Managing the Asian financial crisis and the virtues of democracy

In 1996, five Asian economies (South Korea, Indonesia, Malaysia, Thailand, and the Philippines) received net private capital inflows amounting to \$93.0 billion. One year later (in 1997), they experienced an estimated outflow of \$12.1 billion (IIF 1998), a turnaround in a single year of \$105 billion, amounting to more than ten percent of the combined GDP of these economies! By 1998, three of these economies (Indonesia, Thailand, and South Korea) were mired in a severe economic crisis, the magnitude of which would have seemed inconceivable even to the most knowledgeable and insightful observers of the region just months before.

One lesson of the crisis is that international capital markets do a poor job of discriminating between good and bad risks. It is hard to believe that there was much collective rationality in investor behavior during and prior to the crisis: financial markets got it badly

wrong either in 1996 when they poured money into the region, or they got it badly wrong in 1997 when they pulled back en masse. The implication is that relying excessively on liquid, short-term capital (as all of the three worst affected countries did) is a dangerous strategy.

Second, the crisis has demonstrated that trade orientation per se has very little to do with the propensity to be hit with severe liquidity problems. The Asian economies most affected by the reversal in capital flows were among the most outward-oriented economies in the world, routinely pointed out as examples for other countries to follow. The determinants of the crisis—as with the debt crisis of 1982 and the Mexican peso crisis of 1994—were financial and macroeconomic. Trade and industrial policies were, at best, secondary.³⁷

In keeping with the general theme of this chapter, a third lesson of the crisis is that domestic institutions of conflict management are critical in containing the adverse economic consequences of the initial shock. At the onset of the crisis, it seemed as if authoritarian governments would have a better chance of preventing the potential social explosions that the crisis might create, while “messy” democracies would suffer. In fact, many critics of Western-style liberal democracy viewed the Thai and Korean troubles in the early stages of the crisis—and the apparent Indonesian resolve—as an illustration of the economic superiority of governments based on so-called “Asian Values.” The outcome has been quite the opposite. Indonesia, an ethnically-divided society ruled by an autocracy, eventually descended into chaos, with a reduction in GDP predicted at 20 percent or more. South Korea and Thailand’s democratic institutions, and their practices of consultation and cooperation among social

³⁷ This point is disputed by many, and goes against the official view of the IMF (Fischer 1998). The argument that “structural” aspects of the East Asian model were not at the root of the crisis is well put by Stiglitz (1998) and Radelet and Sachs (1998). This is not to say that these economies did not have structural weaknesses, in particular an over-reliance on governmental steering of the economy that had probably out-lived its usefulness. But as Stiglitz points out, financial crises break out with some regularity in economies ranging from Scandinavian ones to the U.S., having very different types of economic management and standards of transparency.

partners, proved much more adept at generating the requisite policy adjustments. While neither of the two economies was out of the woods as of this writing, their experience has demonstrated the importance of institutions, and of democratic institutions in particular, in dealing with external shocks.

While democratic institutions are relatively recent in Thailand and Korea, they helped these two countries adjust to the crisis in a number of ways.³⁸ First, they facilitated a smooth transfer of power from a discredited set of politicians to a new group of government leaders. Second, democracy imposed mechanisms of participation, consultation, and bargaining, enabling policy makers to fashion the consensus needed to undertake the necessary policy adjustments decisively. Third, because democracy provides for institutionalized mechanisms of "voice," the Korean and Thai institutions obviated the need for riots, protests, and other kinds of disruptive actions by affected groups, as well as lowering the support for such behavior by other groups in society.

In Thailand, the prime minister Chavalit Yongchaiyudh resigned on November 6th, shortly after "several hundred white-collar workers led demonstrations in Bangkok" (Bell 1998) and one month after the adoption of a new, anti-corruption constitution. Three days later, an eight-party coalition led by Chuan Leekpai managed to obtain a majority of votes in parliament. News articles about Thailand abound with stories illustrating the willingness that the Thai people to give the new government the benefit of the doubt in the belief that the government had their best interest in mind. Chuan's new Finance Minister, Tarrin Nimmanahaeminda, related a story

³⁸ Korea was not a democracy in 1980, and its relatively smooth adjustment at the time (recall the comparison with Brazil and Turkey) may call into question the emphasis I place on the importance of democratic institutions in 1997. But Korea had a number important advantages along other dimensions I have also stressed: it had a high quality bureaucracy, high degree of rule of law, relatively small amounts of income inequality, and virtually no ethnic or linguistic cleavages.

to the press about a letter he received from "a young Thai girl wishing him well in his efforts to turn around the economy and enclosing a 20-baht note that she had taken from her father's wallet—her contribution toward paying off the International Monetary Fund." (Time 2/16/98 p21) The government savings bank started a program where people can open accounts designed to ameliorate the situation for those particularly hard hit by the crisis—a campaign referred to as "Thais helping Thais" (Economist 1/24/98, p.38). In a more nationalistic effort, the government has also tried to cushion the employment loss to its own citizens by expelling thousands of foreign workers (particularly the large number of Burmese working there), to demonstrate that "the government is doing its best to protect the livelihoods of its own people" (Economist 1/24/98, p38). As instability has grown in Indonesia, Thailand's currency has strengthened. The IMF has suggested that Thailand might emerge as the leader in recovery from the "Asian Flu." Thailand's relative success thus far in weathering this economic crisis has come, in Chuan's words, from "the utility of a democratic process that gives people the right to choose a government they believe can solve their problems." (Time 3/30/98 p16)

In Korea, Kim Dae Jung, veteran opposition leader of the National Congress for New Politics, ended the former ruling party's half-century of political dominance on December 19th, becoming the first opposition candidate ever elected president in South Korean history. As in Thailand, the transition eased political tensions, and brought in a new team that was not tainted and constrained by previous policies and commitments. Kim has cultivated an alliance with the working classes and the poor, and made a strong commitment to furthering a clean democracy. To this end, he has made an effort to make sure that the people of Korea feel that their voices are being heard. In January 1998, he began hosting "town meetings," in much the same way that Clinton has in the U.S., increasing the accessibility of the president to the people (In These

Times 2/22/98 p15). He has also been working with labor unions on the creation of previously minimal social safety nets in the form of welfare programs, and increased opportunities for job training for the unemployed.

Kim was able to hold off labor unrest for quite an extended period of time by carefully discussing all potential changes and plans for restructuring with union leaders. In fact, some threatened strikes, such as the one by the Korean Confederation of Trade Unions (KCTU), planned for mid-February 1998 to protest a proposed labor reform law (to end lifetime employment by allowing firms to lay off workers in certain circumstances), were called off by the unions themselves, so as not to "endanger the nation's fragile economic recovery." (FT 2/14/98 p2). By mid-April, as the effects of the layoffs started to be felt, strike action increased as well. Despite efforts by the government to negotiate with unions, a nationwide strike on May 27, 1998 by workers demanding more job security brought the stock market to the lowest point in eleven years, a symptom of the mounting tension over South Korea's labor troubles. However, it is estimated that only less than 20 percent of the trade unions' members have taken part in the strike, and it is also the case that the strikes have remained peaceful. South Korea has since begun a second round of labor talks (but without KCTU). Meanwhile, Korean citizens have hurried to turn in their gold jewelry to boost the foreign reserves, and businesses are conserving electricity by allowing elevators to stop on alternate floors only.

This sense of shared sacrifice and compromise has been conspicuous in Indonesia by its absence. The financial difficulties spawned by the economic crisis were exacerbated by Suharto's unwillingness to relinquish power, the lack of voice mechanisms (such as independent parties and free trade unions), and a generalized sense that the costs of the crisis would be passed on to the workers and the poor. Anti-Suharto sentiment welled up and exploded in the form of

violence, riots, and looting, some of which was targeted on the country's ethnic Chinese minority. In order to deflect blame from the government, some officials apparently incited ethnic tensions. According to one human rights group, instead of trying to prevent ethnic unrest, some "senior officials ... have tried to deflect blame for the economic crisis on to prominent members of the ethnic Chinese community" (cited in the *Economist*, 2/28/98, p46). A student demonstration on May 12, 1998 where the military shot and killed six protesters snowballed into massive protests, culminating in President Suharto's final overthrow. Upon Suharto's resignation, the baton was passed on to one of his closest associates, B.J. Habibie, his hand-picked successor. Despite Habibie's efforts to distance himself from Suharto's regime and to appear as democratically reformist as possible, the mood remained volatile at the time of this writing (July 1998).

Discussion

The conventional view among economists and many political scientists is that reforms, of the type that economies in East Asia (and before them in Latin America and elsewhere) were called on to undertake, require insulated, autonomous executives which can act speedily and decisively. In other words, democracy, even when not hostile to reform, complicates it. The systematic evidence from the 1970s and 1980s, as well as the more recent Asian experience, suggests that the opposite is closer to the truth.³⁹

³⁹ The voluminous empirical literature on the long-run consequences of political democracy for economic growth has generally yielded ambiguous results (Bhalla forthcoming; Przeworski and Limongi 1993; Helliwell 1994; Barro 1996). However, more recent studies show that democracies produce a better balance between risk and reward: that is, aggregate economic instability tends to be much lower under democracies. See Rodrik (1997d), Chandra (1998) and Quinn and Woolley (1998). The latter set of findings is consistent with the systematic evidence presented earlier on the superior performance of democracies when confronted with external shocks, as well as with the recent evidence from East Asia.

The sweeping market-oriented reforms that Latin American countries undertook during the last decade have been the product mostly of democratic governments. This has prompted scholars of the region to re-evaluate the relationship between democratic politics and economic management, finding much more good in democracy than in the earlier literature (Dominguez 1998; Hagopian 1998). The experience of the former socialist economies has been similar, suggesting that democratization may be a complement to speedy stabilization and reform (Aslund et al. 1996). An interesting paper by Hellman (1998) concludes: "postcommunist systems with a higher level of political participation and competition [e.g. Poland and the Czech Republic] have been able to adopt and maintain more comprehensive economic reforms than states largely insulated from mass politics and electoral pressure [e.g. Ukraine and Belarus]" (pp. 233-234). In Hellman's view, political systems where power is concentrated allow "winners" to stop reform in its tracks so as to keep access to the rents that partial reforms create. Broader political participation and competition acts as a counterweight to this tendency.⁴⁰

In his 1861 book on Representative Government, John Stuart Mill described the advantages of the democratic form of government (in comparison to dictatorships) in terms that remain highly relevant. One of the special merits of democratic participation in public affairs, he wrote, is that it makes the citizen more willing to see others' points of view, to compromise, and to cooperate. The citizen

is called upon, while so engaged, to weigh interests not his own: to be guided, in case of conflicting claims, by another rule than his private partialities: to apply, at every turn, principles and maxims which have for their reason of existence the common good: and he usually finds associated with him in the same work minds more familiarised than his own with these ideas and operations, whose study it will be to supply reasons to his understanding, and stimulation to his feeling for the general interest. He is made to feel himself one of the public, and whatever is for their benefit to be for his benefit. Where

⁴⁰ There is also some recent econometric evidence suggesting that public investment projects yield higher economic returns in environments with greater civil liberties and democracy (Pritchett and Kaufmann 1998).

this school of public spirit does not exist, scarcely any sense is entertained that private persons, in no eminent social situation, owe any duties to society, except to obey the laws and submit to the government. There is no unselfish sentiment of identification with the public. Every thought or feeling, either of interest or of duty, is absorbed in the individual and in the family. The man never thinks of any collective interest, of any objects to be pursued jointly with others, but only in competition with them, and in some measure at their expense. A neighbour, not being an ally or an associate, since he is never engaged in any common undertaking for joint benefit, is therefore only a rival. Thus even private morality suffers, while public is actually extinct.⁴¹

The passage encapsulates well the contrasting ways in which the citizenry reacted to the exigencies of adjustment in Indonesia on the one hand, and in Thailand and Korea on the other.⁴²

Improving the institutions of conflict management

The world market is a source of disruption and upheaval as much as it is an opportunity for profit and economic growth. Without the complementary institutions at home—in the areas of governance, judiciary, civil and political liberties, social insurance, and education—one gets too much of the former and too little of the latter. The weakness of the domestic institutions of conflict management was the Achilles' heel of the development strategy pursued in Latin America, the Middle East, and elsewhere, and this is what made these countries so susceptible to the external shocks of the 1970s.

This weakness persists. Reforms in the areas of macroeconomic policy, trade policy, deregulation, and privatization have not been matched by deeper reforms of political institutions.

⁴¹ From Chapter 3 of Mill (1861), taken from <http://english-www.hss.cmu.edu/Philosophy/mill-representative-govt.txt>. I owe the reference to this passage to Bell (1998).

⁴² One can re-interpret Mill's discussion also in terms of social capital, a term that is currently much in vogue. Mill's argument is that democracy promotes greater social capital—the capacity to undertake projects for the collective good—by establishing connections among individuals and binding them into civil society. For a recent paper that provides some evidence on "social capabilities" and social capital in fostering growth see Temple and Johnson (1998).

bureaucracies, judiciaries, and social safety nets. As Dominguez (1997, 106-112) argues with reference to Latin America:

Popular democratic representation requires a well-organized and articulate labor movement, capable of functioning in a market economy and standing up for the rights of workers. Democratic politics requires contestation between organized forces; democracy would be wounded if there were no appropriate counterparts to business power.... Though the reasons vary, the role of parliaments and the quality of executive-legislative relations still widely fail to foster the consolidation of democracy ... Compared to the national legislatures of Brazil, Ecuador, Colombia, and Honduras, the U.S. Congress is a model of democratic responsiveness, party discipline, member responsibility, policy attention, and coherence. [In Brazil and Ecuador,] as many as a third of the legislators cross the aisle during one term of office.... Presidentialism—rule by decree—is the natural offspring of such practices.... The turn towards the market [in Latin America] has also coincided with spectacular cases of corruption that led to the impeachments of presidents Collor in Brazil and Perez in Venezuela

and of course the discrediting of Salinas in Mexico.

Meanwhile, the world economy has hardly become a safer place—ask the Thai or the Indonesians if you have any doubt. This leaves developing countries highly vulnerable. Without an internal strategy of institutional reform to complement the external strategy of opening up, they risk exposing themselves to the kinds of protracted crises from which many of them have begun to recover only recently. There are at least three components of such a strategy.

Improving the credibility of the state apparatus

There has been much progress on the macroeconomic policy front in some countries, especially in Latin America. But now this credibility has to be extended beyond the macroeconomic field. There is a great need to improve the quality of the judiciary and of the public bureaucracy, and to root out corruption. The state cannot play the role of honest broker in mediating social conflict—as it does so often in East Asia—if it is not perceived as honest and competent.

Improving mechanisms of voice

There is a need to improve the channels through which non-elites (indigenous peoples, workers, and farmers) can make themselves heard, and to bring them (or their representatives) into the decision-making councils. The top-down, technocratic style that is well-suited to macroeconomic stabilization is not well-suited to the challenges of the second stage of reform. These later reforms will not achieve popular legitimacy unless they are perceived to be the result of a broader deliberation at the national level. Looked at from this perspective, a strong, widely-based trade union movement is a good thing, not a bad thing. Having strong, disciplined political parties is a good thing, not a bad thing. A strong executive is also good, but even better when it uses its autonomy to reach out and strike bargains and alliances with the popular sectors.

Improving social safety nets and social insurance.

It has now become commonplace to point out that market-oriented reforms require social safety nets to prevent individuals from falling through the cracks as economic change unfolds. Social safety nets are in fact part and parcel of modern capitalism, and an important reason for its endurance. As Jacoby (1998, 1) emphasizes, "over the last one hundred years, modern societies have developed a diverse set of institutions for pooling labor-market risk and indemnifying against it."

Yet it is not sufficiently appreciated what an important role social insurance has played in those countries that were most successful in integrating themselves into the world economy in the postwar period (or reintegrating themselves, as in the case of Western Europe). In Western

Europe, the idea of providing social protection in order to insulate and cushion broad segments of society from market risks—particularly those having an external origin—was (and to some extent remains) an ingrained habit. This is evident in the welfare state that has grown during the postwar era and in the huge growth in income transfers. It is only a mild exaggeration to say that the European welfare state was the flip side of the open economy (Rodrik 1997c). In East Asia, the same function was performed not by social programs and income transfers, but by a combination of enterprise policies (such as lifetime employment and the provision of social services), extensive product and labor market regulations (which slowed down the pace of change), and a much more gradual, controlled type of external liberalization.

As is now evident, the approaches in Europe and East Asia both have their problems. However, it is clear that the provision of social insurance is an important component of market reforms—it cushions the blow on those most severely affected, it helps maintain the legitimacy of these reforms, and it avoids a backlash against the distributional and social consequences of integration into the world economy.

Obviously, there is no how-to manual for accomplishing these things. We lack the knowledge that would help us design the appropriate institutions of conflict management, especially where the representation of “voice” is concerned. The issues are complex and deserve much more thought and space than I have given them here. It is a fair bet that we will need a considerable amount of institutional innovation and experimentation before we develop strong intuitions about the kinds of mechanism that have to develop. From the perspective of this essay, however, the key is to recognize that institutions of conflict management are a necessary complement to openness. In the absence of such institutions, openness is likely to foster

domestic social conflicts which will prove damaging not only in their own right, but will be also detrimental to economic growth in the long run.

Concluding remarks

I have argued that the development community has internalized the wrong lessons from the experience of countries in Latin America and elsewhere which adopted the ISI strategy. The correct interpretation goes something like this:

- First, ISI worked rather well for a period of about two decades. It brought unprecedented economic growth to scores of countries in Latin America, the Middle East, and North Africa, and even to some in Sub-Saharan Africa.
- Second, when the economies of these same countries began to fall apart in the second half of the 1970s, the reasons had very little to do with ISI policies per se or the extent of government interventions. Countries that weathered the storm were those in which governments undertook the appropriate macroeconomic adjustments (in the areas of fiscal, monetary and exchange-rate policy) rapidly and decisively.
- Third, and more fundamentally, success in adopting these macroeconomic adjustments was linked to deeper social determinants. It was the ability to manage the domestic social conflicts triggered by the turbulence of the world economy during the 1970s that made the difference between continued growth and economic collapse. Countries with deeper social divisions and weaker institutions of conflict management experienced greater economic deterioration in response to the external shocks of the 1970s.

Taken together, these points provide an interpretation of recent economic history that is at odds with much current thinking. By emphasizing the importance of social conflicts and

institutions—at the expense of trade strategy and industrial policies—they also suggest quite a different perspective on development policy. If I am right, the main difference between Latin America, say, and East Asia was not that the former remained closed and isolated while the latter integrated itself with the world economy. The main difference was that the former did a much worse job of dealing with the turbulence emanating from the world economy. The countries that got into trouble were those that could not manage openness, not those that were insufficiently open.

Hence improving the quality of institutions of conflict management is a critical complement to openness. These institutions help adjudicate distributional contests within a framework of rules and accepted procedures—that is, without open conflict and hostilities. Democratic institutions, an independent and effective judiciary, an honest and non-corrupt bureaucracy, and institutionalized modes of social insurance are among the most significant of conflict-management institutions. I have shown in this chapter how such institutions have had demonstrable benefits—and in the case of countries lacking them, severe adverse effects—in terms of economic performance subsequent to the shocks of the 1970s.

The recent Asian crisis provides further support for this perspective, and once again highlights the important role played by institutions of conflict management. In Korea and Thailand, where new democratic institutions provide for mechanisms of voice and contestation, political systems have turned out to be better, at least so far, at delivering adjustment policies than in Indonesia where a personal dictatorship proved to be the recipe for descent into chaos.

To conclude, conflict-management institutions play a far more important role in generating the capacity to handle external turbulence than conventional economic analysis has generally allowed. The evidence reveals a certain number of “stylized facts” regarding which

types of social and political arrangements work better than others. but clearly we need to learn a lot more. More research, particularly of a cross-disciplinary kind. is needed to sharpen understanding of these links.

Chapter 5: Is Africa Different?

The answer to the question posed by this chapter's title. I shall argue, is "no." To be sure, Sub-Saharan Africa is poorer than any other region in the world, and many of its economies have declined much more precipitously than elsewhere. The region faces much greater public-health challenges, and it suffers from severe climactic and geographical disadvantages. But the basic lessons for economic policy that I have discussed in the preceding chapters apply equally well to the African countries. Since most of the African economies are small, they cannot afford to close themselves off from the world economy—perhaps more than any other region, they need imports of capital goods, of intermediate inputs, and of ideas. At the same time, it is important to realize that openness is no panacea, and that it has to be complemented with domestic investment and with better institutions of conflict management in order to yield sustainable economic growth.

I will argue that trade policy in Sub-Saharan Africa works much the same way that it does elsewhere.⁴⁵ High levels of trade restrictions (as well as overvalued currencies) have seriously discouraged exports in the past, and their reduction can be expected to result in significantly improved trade performance in the region. The removal of export restrictions, dismantling of marketing boards, relaxation of quantitative restrictions on imports, and lowering of import tariffs will sharply increase traditional and non-traditional exports. There is little reason for pessimism in this respect, or for concern that Africa's different conditions—its poor infrastructure, its geography, or its dependence on a limited number of primary products—make it a special case in which exports are not responsive to prices or to the traditional instruments of commercial policy.

While trade reforms are a potent instrument for raising trade volumes, the evidence suggests that their influence on economic growth is generally much weaker. As I have argued before, an increase in the share of national income that is exported does not in itself generate growth in per-capita income. This is as true in Africa as it is elsewhere. Over the 1964-94 period, there were five countries in Africa that increased the dollar value of their exports of manufactures to the OECD at an annual average rate of 20 percent or more: Mauritius, Mali, Burkina Faso, Cote d'Ivoire, and Niger. Only the first of these countries is an unqualified success story.

The fundamentals for long-term growth are investments in physical capital and human resources. These are in turn made possible by physical infrastructure, macroeconomic stability, the rule of law, and solid institutions. Governments that focus their efforts in these areas will be rewarded with increased rates of economic growth.

The role of trade policy in economic growth in Africa is largely auxiliary and of an enabling nature: extremes of export taxation and import restrictions can surely suffocate nascent economic activity, but an open trade regime on its own will not set an economy on a sustained growth path. Too much focus on "outward orientation" and "openness" can even be counterproductive if it diverts policy makers' attention away from the fundamentals listed above and results in treating trade rather than per-capita income as a yardstick of success.

An overview of African economic performance

In the last three years, Africa has had the benefit of some of the highest growth rates experienced in the region in at least a decade. Along with a wave of political change and

⁴³ Parts of this chapter draw heavily on Rodrik (1997b).

democratization, this performance has generated a degree of optimism about Africa's future, raising hopes that the region's 600 million people can be eventually lifted out of poverty and destitution. But optimism has to be tempered by the fact that the fastest growing countries in Sub-Saharan Africa have only begun their recoveries from debilitating civil wars or long periods of economic decline. For many of them, it will require growth at East Asian rates for the better part of a decade just to make up for lost ground. There are at least ten countries in the region where GDP per capita is lower now than it was in 1960.⁴⁴ Uganda and Ghana, the two most aggressive reformers, still have to catch up with their 1970 level of per-capita GDP despite substantial gains since the mid-1980s.

However, economic growth has not been dismal in all countries of the region. Over the entire 1960-94 period, three countries have experienced growth of three percent or more in real per-capita GDP per annum (Botswana, Lesotho, and Mauritius), and at least three more have surpassed two percent (Seychelles and Swaziland; see Table 5.1). Many others have experienced high growth over a period of a decade or more: Cote d'Ivoire, Gabon, Kenya, and Togo during 1960-73, and Congo and Cameroon during 1973-84, for example. An important message that comes out of Table 5.1 is that African countries are able to grow at satisfactory rates over extended periods when the circumstances are right. This is a useful message as it allows us to be optimistic about the prospects for the region.

As in other regions, investment has made a big difference to economic performance over the long run. Investment rates in Africa have tended to be quite low by international standards. At international prices, the average investment rate in Sub-Saharan Africa over the 1960-89

⁴⁴ According to World Bank data, these are Central African Republic, Chad, Ghana, Madagascar, Niger, Rwanda, Senegal, Sudan, Tanzania, Zambia.

Table 5.1

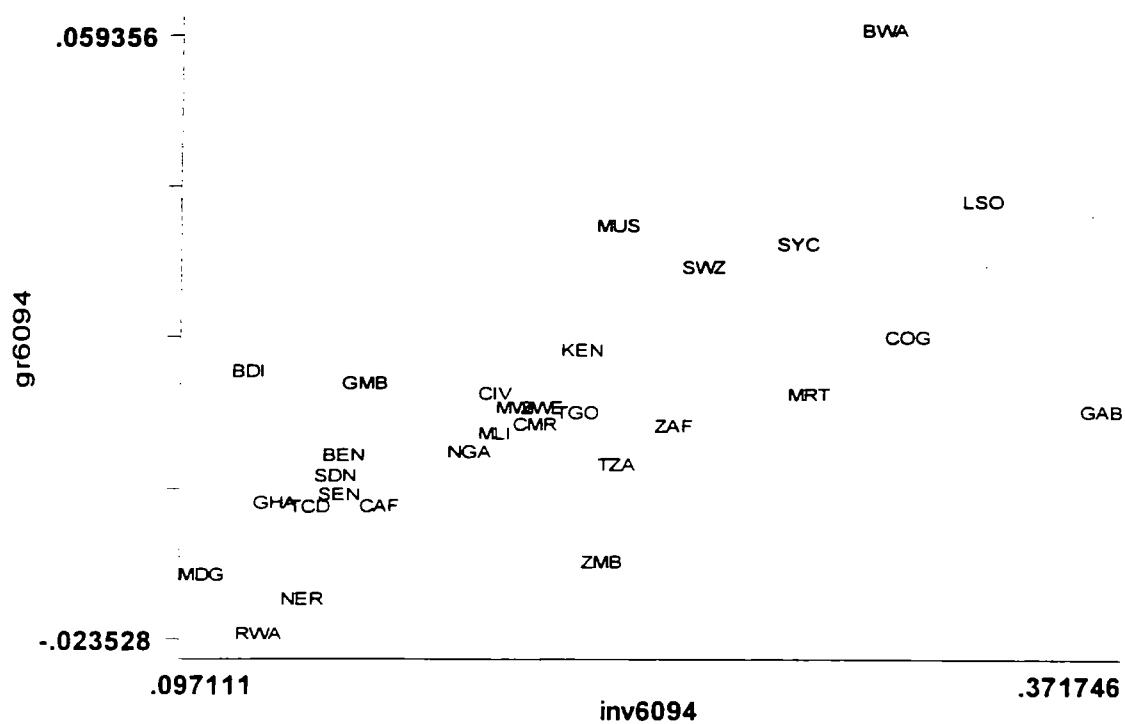
Per-capita GDP growth rates in Sub-Saharan Africa (percent)

<i>Country Name</i>	<i>1960-94</i>	<i>1960-73</i>	<i>1973-84</i>	<i>1984-94</i>
Benin	0.10	0.29	0.16	-0.22
Botswana	5.94	6.15	7.34	4.11
Burkina Faso	n.a.	n.a.	1.75	0.53
Burundi	1.26	2.95	0.86	-0.51
Cameroon	0.53	0.97	4.68	-4.62
Cape Verde	n.a.	n.a.	6.32	2.45
Central African Republic	-0.60	0.26	-0.81	-1.49
Chad	-0.61	-1.75	-1.17	1.48
Comoros	n.a.	n.a.	n.a.	-1.39
Congo	1.72	2.46	5.75	-3.69
Cote d'Ivoire	0.95	5.63	-0.20	-3.88
Ethiopia	n.a.	n.a.	n.a.	-0.38
Gabon	0.71	4.72	0.43	-4.20
Gambia, The	1.09	2.80	1.27	-1.33
Ghana	-0.55	0.03	-2.96	1.34
Guinea-Bissau	n.a.	n.a.	-1.41	2.13
Kenya	1.54	3.40	0.25	0.54
Lesotho	3.57	4.94	1.75	3.80
Liberia	n.a.	1.28	-2.53	n.a.
Madagascar	-1.54	-0.33	-2.63	-1.91
Malawi	0.76	2.85	0.78	-1.98
Mali	0.39	0.32	0.11	0.80
Mauritania	0.93	2.85	-0.83	0.38
Mauritius	3.24	3.14	0.96	5.22
Mozambique, Rep. of	n.a.	n.a.	n.a.	3.96
Namibia	n.a.	n.a.	n.a.	0.31
Niger	-1.87	-2.00	-1.85	-1.74
Nigeria	0.14	1.27	-2.53	1.62
Rwanda	-2.35	-0.77	2.08	-9.29
Sao Tome and Principe	n.a.	n.a.	0.33	-0.45
Senegal	-0.44	-0.44	-0.22	-0.67
Seychelles	2.98	2.67	2.34	4.09
Sierra Leone	n.a.	n.a.	0.98	-3.20
Somalia	n.a.	-0.95	-0.12	n.a.
South Africa	0.50	2.39	0.19	-1.62
Sudan	-0.18	-1.79	1.76	-0.23
Swaziland	2.67	6.74	0.14	0.16
Tanzania	-0.03	2.64	-3.65	0.50
Togo	0.69	4.17	-0.60	-2.42
Uganda	n.a.	n.a.	n.a.	1.40
Zaire	n.a.	n.a.	-3.24	n.a.
Zambia	-1.36	0.63	-2.85	-2.32
Zimbabwe	0.75	2.58	-0.85	0.16
	n.a.	n.a.	n.a.	n.a.
Average	0.70	1.88	0.31	-0.31

Source: World Bank data.

Figure 5.1

Relationship between investment and growth in Sub-Saharan Africa, 1960-94



Source: World Bank data.

Notes: inv6094 and gr6094 are the investment shares in GDP and growth rates over 1960-94, respectively.

period was eleven percent (of GDP), which is half the rate for East Asia (22 percent) and substantially below the rate for Latin America (17 percent).⁴⁵ Focusing on African countries alone, differences in investment rates have been perhaps the most important determinant of variation in long-term growth rates. As Figure 5.1 shows, there is a tight relationship between investment/GDP ratios in individual countries and per-capita growth rates over 1960-94. Countries that have grown fast (such as Botswana and Mauritius) have had much higher investment rates than the laggards (such as Rwanda, Madagascar, or Niger). While some countries have grown less rapidly than what their investment rates would indicate (e.g., Zambia), these are the exceptions, and not the rule.

As the previous set of figures showed, Africa has experienced enormous instability in economic performance. Just to cite one important example, Cote d'Ivoire has been transformed from one of the miracle economies of Africa during 1960-73 (with a growth rate of per capita income of 5.6 percent) to a basket case during 1984-94 (with a growth rate of -3.9 percent). Resource booms and cycles in commodity prices account for some, but not all, of these ups and downs. As I argued in the previous chapter, the inability to respond to these cycles with appropriate macroeconomic policies has magnified the economic consequences of external volatility. In Cote d'Ivoire's case, for example, the fixed exchange rate of the CFA franc proved to be a disaster once coffee and cocoa prices collapsed.

More fundamentally, the maintenance of macroeconomic stability in Africa has been hampered by weak institutions of conflict management. In this sense, the African experience is qualitatively no different from that of the other regions on which I focused in the previous chapter, except insofar as ethnic divisions are generally a more serious problem in Africa. The

⁴⁵ Based on internationally comparable statistics from the Penn World Tables.

weakness of public institutions and in governance styles has made Africa an excessively high-risk environment (Collier 1995), depressing private investment levels.

It is the case that African countries with relatively greater civil liberties and political rights have had higher-quality institutions and have been more adept at dealing with shocks. This is shown in Figure 5.2, which is reminiscent of Figures 4.5 and 4.6 in the previous chapter, but is restricted to a sample of Sub-Saharan African countries.⁴⁶ While most African countries have been autocracies until recently, those among them with more democratic institutions—Mauritius, Botswana, and Seychelles—have adjusted to terms-of-trade and other external shocks much better. Mauritius is a particularly significant example, as it is a society with deep ethnic divisions (Creole, Indian, Franco-Mauritian, and others) and one that was perceived to face very poor economic prospects at the time of independence (in 1968). Democracy has enabled major Mauritian social actors (including ethnic groups) to be drawn into decision-making councils, and has produced relatively generous social policies that maintain social peace despite a turbulent history.⁴⁷

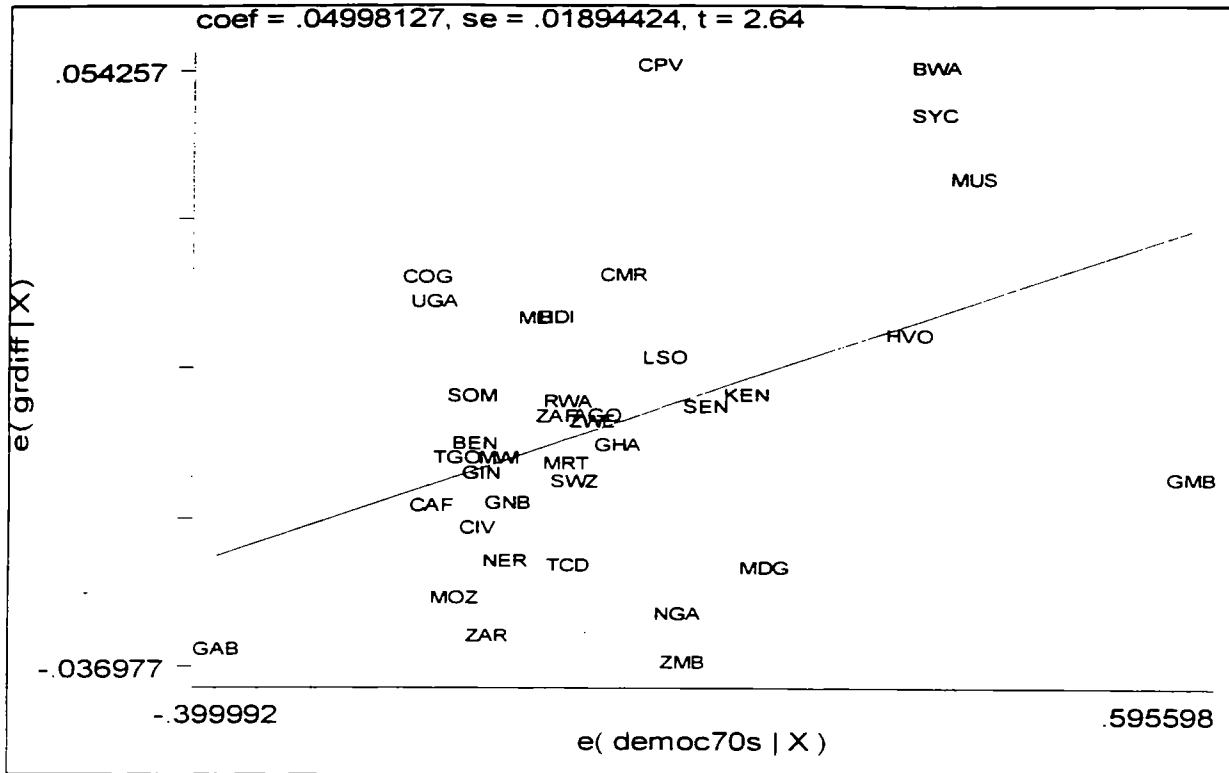
These pieces of evidence give reason to believe that the democratic transitions in Africa may eventually prove to be a boon on economic grounds as well. As Barkan and Gordon (1998) emphasize, the two countries with the most favorable long-term growth records in Africa are the ones with longest records of democratic rule, Botswana and Mauritius. Growth has recently returned to Benin, Ghana, Mozambique and South Africa, countries where democratization has

⁴⁶ As in the previous chapter, growth in 1960-75 and log per-capita GDP in 1975 have been included as additional right-hand side variables. The variable on the vertical axis, as before, is the difference in growth rates between the two periods (1989-75 minus 1960-75).

⁴⁷ See Brautigam (1997) for a useful account.

Figure 5.2

Relationship between growth declines after 1975 and civil liberties and political rights in Sub-Saharan Africa



Notes: The variable on the vertical axis is the (unexplained part of the) difference in growth rates between 1975-89 and 1960-75. The variable on the horizontal axis is the component of the democracy index that is orthogonal to the other explanatory variables.

gone farthest. In the words of Barkan and Gordon (1998, 108), “the clear lesson from Africa is that economic renewal and democratization go hand in hand.”⁴⁸

Why is Africa “marginalized” in world trade?

Trade restrictions in Sub-Saharan Africa have been generally high, and they have come down only slowly, and with much equivocation. Comparative evidence on regional trade barriers was presented earlier in Chapter 1. This evidence shows that, until the early 1990s, trade barriers in Africa were comparable in magnitude to those prevailing in Latin America. But, as the tables also show, the region’s policy makers have displayed much less enthusiasm for the kind of sweeping trade reforms that have recently taken place in Latin American economies—as well as in most of the former socialist economies of Eastern Europe and central Asia. While tariff and non-tariff barriers have come down, and currencies have depreciated, the level of trade restrictions remains higher in Sub-Saharan Africa than in any other region. Most African countries chose not to take advantage of the Uruguay Round to bind their tariffs at low levels. Tariffs were typically bound at levels far exceeding current levels, and often at levels exceeding 100 percent (Harrold 1995).

Sub-Saharan Africa’s trade has grown quite slowly since the 1950s, with the result that the region’s share in world trade stands today at around one percent, down from more than three percent in the mid-1950s (Yeats 1997, 1). However, Africa’s marginalization in world trade is primarily due to the continent’s lagging performance in terms of output growth. It is not due to trade ratios (relative to GDP) that have declined or are low by cross-national standards. As I will

⁴⁸ See also the recent paper by Collier (1998) which emphasizes the positive role of democracy in managing conflict in ethnically-divided African societies.

show below, African countries trade on average as much as would be expected by international norms once their income levels and size are taken into account. It is because they have failed to expand their economies at sufficient rates that their importance in world trade has shrunk. Consequently, the way to reverse the trend is not to target the region's trade volumes per se, but to raise overall growth rates.

Figure 5.3 shows the trends in export-GDP ratios since 1960 by regional groupings. At constant relative prices, this ratio has remained more or less stable in Sub-Saharan Africa in the 26-30 percent range, and if anything, it has increased since the early 1980s. The figure makes clear that the region is not an outlier in terms of the trends observed in other regions. East Asia's export ratio has increased the most, but even in this case, the phenomenal rise in that region's importance in world trade is clearly due to its very rapid output growth rather than the increase in its export-GDP ratio.

Table 5.2 shows the results from cross-national regressions where I use a large sample of countries to relate the observed shares of exports in GDP to levels of national incomes per capita and to country size.⁴⁹ In each case, I include a dummy variable for Sub-Saharan Africa (as well as other country groupings) to check whether the estimated coefficient is negative and statistically significant, as it would be if the region were an under-performer.

The regression in column (1) shows that country size (as measured by population and land area) and per-capita income are very strong determinants of the openness of an economy. Smaller and richer countries trade more (as a share of their GDP). The estimated coefficients imply that a doubling of per-capita income increases exports by ten percent of GDP while doubling country size decreases them by four to six percent. In column (2), I have added as a

⁴⁹ In Rodrik (1997b), I report similar results where the dependent variable is the sum of exports and imports in GDP at internationally comparable prices.

Figure 5.3

Exports of goods and services
(as a share of GDP, in 1987 constant prices, unweighted average)

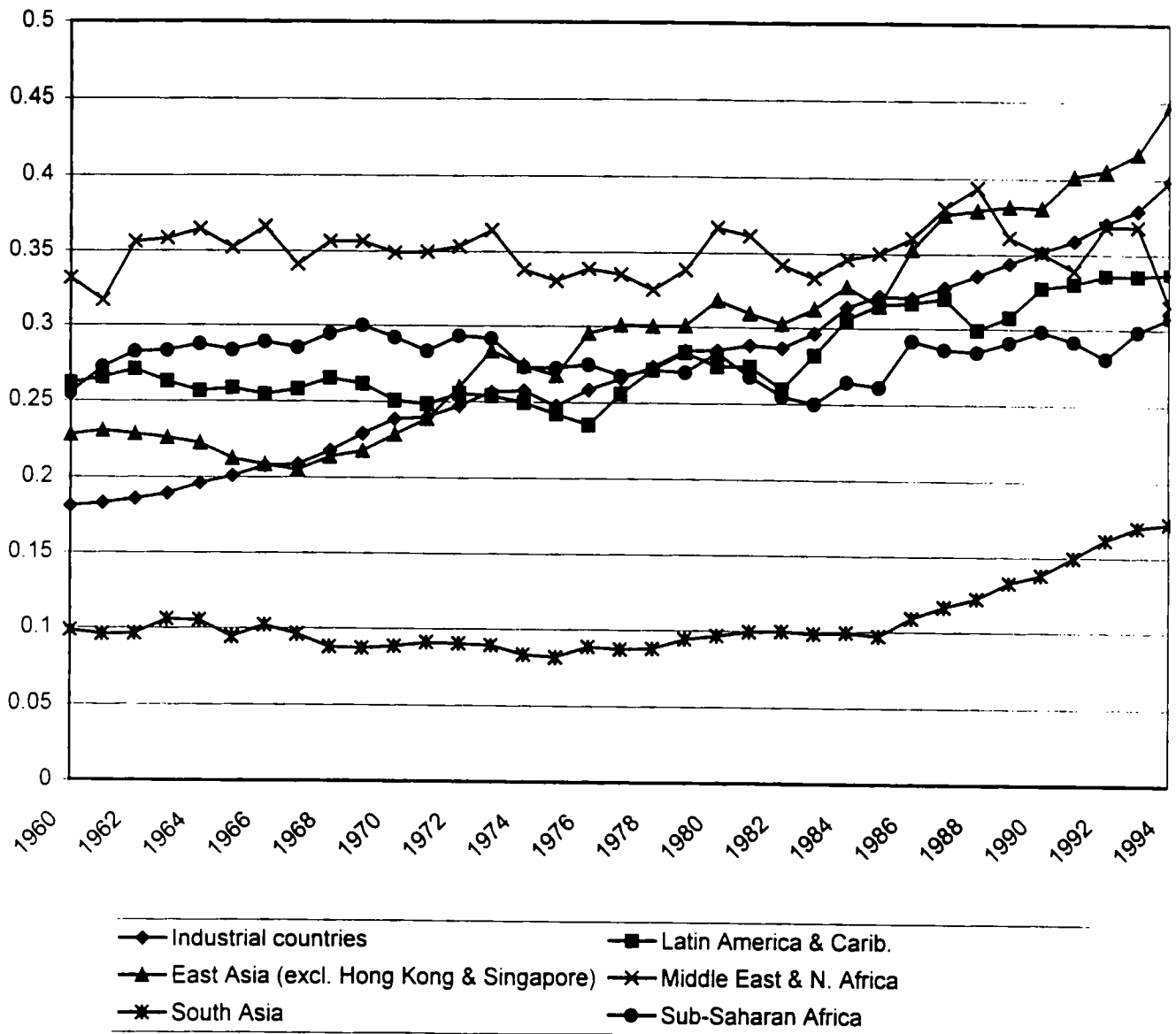


Table 5.2

Does Africa trade too little?

	<i>dependent variable: ratio of exports to GDP, 1990-94</i>		
	(1)	(2)	(3)
SSA	0.10 (0.07)	0.06 (0.09)	-0.02 (0.03)
East Asia	0.49* (0.08)	0.47* (0.14)	0.46** (0.18)
Latin America	0.04 (0.06)	0.03 (0.06)	0.03 (0.04)
ln (per-cap. income)	0.10* (0.03)	0.09** (0.03)	
ln (population)	-0.04** (0.02)	-0.05*** (0.03)	
ln (land area)	-0.06* (0.01)	-0.06** (0.03)	
ln (distance)		0.002 (0.062)	
"gravity" component of openness ^a			0.44* (0.14)
constant	0.50 (0.38)	0.68 (0.58)	0.20* (0.03)
R ²	0.63	0.62	0.49
N	100	80	108

Notes: ^a Based on Frankel and Romer (1996).

Heteroskedasticity-consistent standard errors are in parentheses.

Levels of significance: * 99 percent; ** 95 percent; *** 90 percent.

regressor a measure of geographical distance from the world's leading traders (taken from Barro and Lee 1994). This variable enters with an insignificant coefficient, and its presence makes little difference to the estimated coefficients on the other regressors. Finally, in column (3) I include a measure of the gravity component of trade, drawn from the work of Frankel and Romer (1996), who have estimated the expected volume of trade for a large sample of countries based purely on geographical determinants.

In none of these regressions is the estimated coefficient on the dummy variable for Sub-Saharan Africa statistically significant. Once size and per-capita income are controlled, African countries on the whole do not appear to be outliers. In the first two regressions, the estimated coefficient is actually positive (indicating that, if anything, Africa exports more than is expected on the basis of income levels and size). In the third regression, the coefficient turns negative but is very small (and insignificant). The bottom line is this: Africa trades on average as much as is to be expected given its geography and its level of per-capita income.⁵⁰ A recent, more extensive study by Coe and Hoffmaister (1998), based on bilateral trade flows and using a wider range of geographical controls, has reached the same conclusion.⁵¹

Therefore, the marginalization of Africa in world trade is the consequence of two factors: first, Africa's GDP per-capita has grown slower than other regions'; and second, the elasticity of

⁵⁰ One might ask how this result is consistent with the evidence that (a) trade barriers remain on average higher in Africa (as discussed before); and (b) trade barriers do have significant negative effects on trade volumes in Africa (as will be shown shortly). The answer must lie in other characteristics specific to Africa, which on their own would have boosted trade volumes beyond what is "normal" by cross-country benchmarks. The continent's excessive reliance on natural-resource exports is one plausible candidate. Note, moreover, that this finding does not preclude the possibility that there exists many countries in Africa that significantly under-trade.

⁵¹ In the words of the authors, "if anything, the average African country tends to overtrade compared with developing countries in other regions, although the degree to which Africa overtrades has steadily declined over the past two and one-half decades" (Coe and Hoffmaister 1998, 6). Wood and Mayer (1998) have analyzed a different but related question: is the structure of exports in Africa, especially the low share of manufactures, an outlier relative to cross-country norms? Their finding is that the low share of manufactures is mostly related to Africa's unusual combination of low level of human resources with its high levels of natural resources.

trade with respect to output exceeds unity. As other countries have grown, their trade volumes have expanded more than proportionately. Taking the region as a whole, there is little evidence that trade policies have repressed trade volumes below cross-national benchmarks, unless they have done so indirectly through their depressing effect on incomes.⁵² The encouraging message is that the answer to Africa's trade woes is the same as the answer to its broader economic difficulties: a rise in per-capita income. Once the focus is shifted away from trade to economic growth in general, we are forced to think more broadly about the whole range of growth determinants, and not just about impediments to exchanges at the border.

What determines trade performance in Africa?

Averages for Sub-Saharan African trade performance hide tremendous variation across countries. As is true with growth, there are many examples of good performance alongside the better known cases of dismal failure. How much of the variation in trade performance within Africa is due to differences in exogenous and uncontrollable factors such as geography and the external terms of trade, and how much to differences in domestic policies? The evidence suggests that geography and trade policy both play an important role, while the terms of trade have no perceptible impact.

⁵²The conventional wisdom holds commercial policies responsible. Yeats, for example, lays the blame for Africa's marginalization in trade on domestic interventions in the areas of trade policy and transport policy. He concludes: "If Africa is to reverse its unfavorable export trends, it must quickly adopt trade and structural adjustment policies that enhance its international competitiveness and allow African exporters to capitalize on opportunities in foreign markets" (1997, 24). Similarly, Collier links the declining importance of Africa in world trade to the fact that "its economies have become more inward-looking while all other economies have become more integrated into the world economy" (1995, 541). After talking about higher trade restrictions in Africa, an IMF report concludes: "At least partly because of such policies, the Sub-Saharan African share of world trade fell from roughly 3 percent in the mid-1950s to just over 1 percent in 1995" (IMF 1997, p. 92).

These conclusions come out of a set of regressions based on pooled cross-section, time-series data. I have split the 1964-94 period into three sub-periods (1964-74, 1975-84, and 1985-94) to provide up to three observations per country. The dependent variables are the shares of trade in GDP (either total trade or exports) and their rate of growth. These are regressed on a range of determinants, including trade policies, income levels, and geographic variables. The sample is made up of 37 Sub-Saharan African countries.⁵³

Table 5.3 shows the first set of results on trade shares. The dependent variable here is either the sum of exports and imports as a share of GDP $((x+m)/y)$ or just the share of exports (x/y) . As regressors, I include the following in addition to trade policy indicators: the logs of (initial) per-capita income and population, a dummy for land-locked countries (*access*), and a measure of the proportion of a country's land area which is subject to a tropical climate (*tropics*). The last two variables are taken from Sachs and Warner (1997). The estimated coefficients on these regressors confirm that trade volumes (in relation to national output) tend to rise with levels of income and fall with population. Being landlocked and in the tropics depresses trade.⁵⁴

The regressions indicate that trade restrictions also make a significant difference. I calculated the ad-valorem equivalent of international trade taxes by dividing tax revenue from all border taxes by the volume of total trade. Obviously, this indicator has shortcomings as a measure of the restrictiveness of trade policies. It underestimates the effects of extremely high taxes which result in little revenue, ignores non-tariff barriers and the role of implicit export

⁵³ For more details, see Rodrik (1997b).

⁵⁴ The only countries for which *tropics* is less than one are Botswana (0.5), Lesotho (0), Madagascar (0.9), Mauritania (0.8), and Swaziland (0). One could also read this variable as a dummy for SACU (South African Customs Union). However, adding a separate dummy for SACU countries (Botswana, Lesotho and Swaziland) does not affect the magnitude and statistical significance of the coefficient on *tropics*.

Table 5.3

Determinants of trade volumes in Sub-Saharan Africa

	dependent variable									
	(x+m)/y					x/y		(x+m)/y	x/y	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
<i>taxes on trade</i>	-1.99* (0.37)		-2.11* (0.40)		-1.97* (0.44)	-1.20* (0.23)			-0.93 (0.74)	-0.84** (0.35)
<i>import taxes</i>		-0.82* (0.31)		-1.37* (0.38)			-0.39** (0.21)	-0.85* (0.22)		
<i>export taxes</i>		-1.10* (0.22)		-0.86* (0.26)			-0.52* (0.12)	-0.34** (0.14)		
<i>black market premium</i>			-0.02** (0.01)	-0.03** (0.01)	-0.03* (0.01)			-0.01*** (0.01)		
<i>non-tariff barriers</i>					-0.08 (0.07)			-0.05 (0.04)		
<i>log per-cap. income</i>	0.11* (0.04)	0.12* (0.04)	0.10** (0.04)	0.12* (0.04)	0.14* (0.05)	0.13* (0.03)	0.14* (0.03)	0.13* (0.03)	0.13*** (0.08)	0.10* (0.04)
<i>log population</i>	-0.11* (0.19)	-0.11* (0.02)	-0.11* (0.02)	-0.11* (0.02)	-0.09* (0.02)	-0.04* (0.01)	-0.04* (0.01)	-0.02*** (0.01)		
<i>access</i>	-0.05 (0.04)	-0.03 (0.04)	-0.07*** (0.04)	-0.07*** (0.04)	-0.01 (0.04)	0.002 (0.02)	0.01 (0.03)	0.02 (0.03)		
<i>tropics</i>	-0.58* (0.09)	-0.50* (0.09)	-0.62* (0.10)	-0.57* (0.10)	1.44* (0.42)	-0.08 (0.07)	-0.04 (0.08)	0.61** (0.29)		
country dummies	no	no	no	no	no	no	no	no	yes	yes
N	92	91	83	82	54	92	91	54	93	93
R ²	0.78	0.79	0.81	0.81	0.74	0.67	0.63	0.73	0.34	0.55
Root MSE	0.16	0.16	0.15	0.16	0.13	0.10	0.11	0.07		

Note: Regressions are performed on pooled data covering period averages for 1964-74, 1975-84, and 1985-94

All regressions include dummies for each of the periods (coefficients not shown). Robust standard errors are reported in parenthesis. Levels of statistical significance are as follows.

- 99% level
- ** 95% level
- *** 90% level

taxation through commodity boards, and overlooks the role of smuggling.⁵⁵ But the indicator has the advantage that it is available for a large number of African countries. In addition, it is one of the few trade-policy measures for which a consistent time series can be constructed for most African countries, allowing us to exploit the time-series dimension in the data.

This measure of trade taxation correlates very strongly, and negatively, with trade performance. Moreover, import taxes and export taxes enter individually with statistically significant coefficients. The magnitude of the estimated coefficients on import and export taxes are generally statistically indistinguishable from each other, regardless of whether exports or total trade is used. This is a remarkable confirmation of the Lerner symmetry theorem, which says that import taxes are equivalent to export taxes, and vice versa, in all respects.⁵⁶ The estimated coefficients suggest that a reduction in import or export taxes of ten percentage points boosts exports by about five percentage points of GDP. A visual sense of the impact is provided in Figure 5.4, which shows a partial scatter plot relating export shares to trade taxes. I also find that black-market premia enter with negative and statistically significant coefficients.

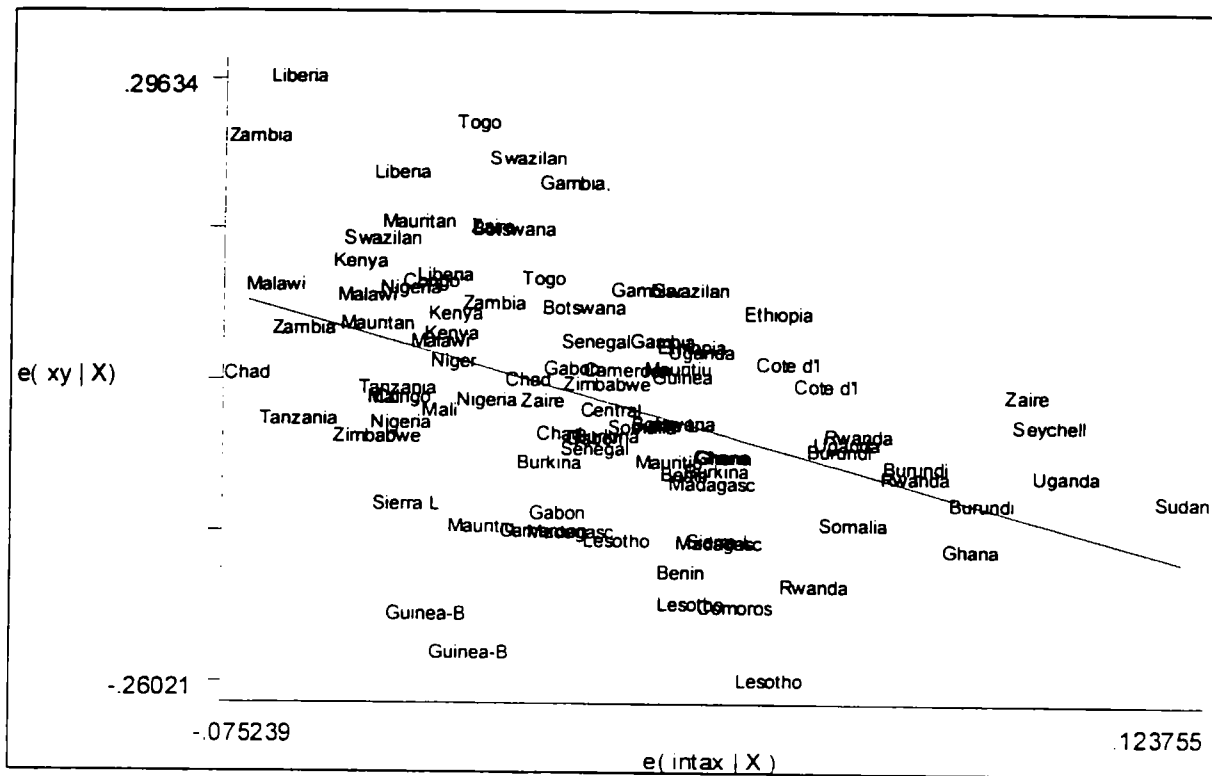
The last two columns of Table 5.3 show the results when a full set of country fixed effects are included. (Period effects are included in all of the regressions.) The coefficient on trade taxes remains negative and large, and is either significant or borderline significant in the case of the export equations. This is striking in view of the fact that with a full set of country

⁵⁵ In addition, there is an econometric problem. The dependent variable, which is the volume of trade (as a share of GDP), enters the construction of the trade-tax measure in the denominator. This raises the possibility of a spurious negative correlation between the two variables. But there are reasons to believe that this is not a serious source of bias. For example, I find that import taxes tend to depress export volumes (as well as the growth of exports), even though the construction of these two variables is independent. Also the results are quite similar using partner-country trade data (reported in Rodrik 1997b).

⁵⁶ In practice there are some good reasons why the Lerner theorem need not apply perfectly, including complications that arise from unbalanced trade and the difficulty of calculating equivalences in a multi-good world with varying tariff/subsidy rates. See Helleiner (1995) for a useful practical discussion to the issues.

Figure 5.4

Partial scatter plot of export/GDP ratios against trade taxes



Notes: The variable on the vertical axis is the (unexplained part of the) export-GDP ratio. The variable on the horizontal axis is the component of the average tax rate on international trade that is orthogonal to the other explanatory variables. There is a maximum of three observations for each country, corresponding to the periods 1964-74, 1975-84, and 1985-94.

dummies, the effect of trade taxes on exports is identified purely from the time-series variation within each country, which in this case is limited to a maximum of three observations.

The R^2 's are in the range of 0.63-0.81, indicating that a relatively small number of variables (country size, per-capita income, geography, and taxation of trade) account well for the variation in trade shares in the region. I have tried a number of additional explanatory variables, but the results remain largely unaltered. In particular, I experimented with the external terms of trade and found that neither the growth rate of the terms of trade over this period, nor its volatility enters the regression with anything approaching statistical significance.

In Table 5.4, I check how well the same set of explanatory variables does in explaining growth of trade over the 1964-94 period. The dependent variable in these regressions is the average growth rate of the trade shares used in Table 5.3. The fit of these regressions is significantly worse, with R^2 's in the range 0.08-0.29. This is mainly due to the fact that the exogenous variables (initial per-capita income, country size, and geography) do not seem to play a significant role in determining changes in the volume of trade. However, there is evidence that trade taxes and black-market premia both have significant depressing effects on export growth. According to the results in column (2), a ten percent increase in taxes on all trade is associated with a reduction in export growth (as a share of GDP) of three percent per annum. Strikingly, trade taxes remain a statistically significant determinant of trade growth even after a full set of country fixed effects is introduced (column 5). Again, the terms of trade apparently play no role (results not shown).

The main conclusion to be drawn from these regressions is that trade policies matter in Sub-Saharan Africa, both in determining the volume of trade and the growth thereof. As suggested by economic theory, import restrictions act as export restrictions. The variation in the

Table 5.4

Determinants of growth of trade in Sub-Saharan Africa

	<i>dependent variable: growth of</i>					
	$(x+m)/y$	x/y				$(x+m)/y$
	(1)	(2)	(3)	(4)	(5)	(6)
<i>taxes on trade</i>	-0.14 (0.11)	-0.32* (0.11)		-0.28** (0.13)	-0.33** (0.15)	-0.72* (0.27)
<i>import taxes</i>			-0.18** (0.09)			
<i>export taxes</i>			-0.14*** (0.08)			
<i>black market premium (/100)</i>				-0.57** (0.24)	-0.52** (0.24)	
<i>non-tariff barriers</i>					0.02 (0.03)	
<i>log income (/100)</i>	-1.32 (0.81)	-1.74** (0.82)	-1.36*** (0.79)	-1.66*** (0.91)	-3.98** (1.72)	-5.19** (2.60)
<i>log pop (/100)</i>	-0.01 (0.37)	-0.16 (0.37)	-0.19 (0.39)	0.22 (0.45)	-0.44 (0.88)	
<i>access (/100)</i>	-0.14 (1.11)	-1.29 (1.20)	-1.16 (1.22)	-1.38 (1.23)	-3.64*** (2.02)	
<i>tropics (/100)</i>	-1.81 (1.37)	-2.27 (1.49)	-1.34 (1.59)	2.51 (1.67)	-35.4** (16.3)	
<i>country dummies</i>	no	no	no	no	no	yes
N	92	83	83	75	47	84
R ²	0.08	0.13	0.13	0.15	0.29	0.05
Root MSE	0.04	0.04	0.04	0.04	0.05	

Note: Robust standard errors are reported in parenthesis. Period dummies are included in all specifications (coefficients not shown). Levels of statistical significance are as follows:

* 99% level

** 95% level

*** 90% level

trade-GDP ratios among SSA countries can be explained well by a small number of determinants, namely income per-capita, country size, geography, and trade policy. The variation in the growth of trade is less well-explained, but there is strong evidence that trade taxes play a significant role here as well.

The determinants of economic growth within Africa

The sources of low growth in African countries have been scrutinized in a number of studies. Easterly and Levine (1997) and Sachs and Warner (1997) are two recent analyses that have received wide attention. These two papers reach somewhat different conclusions: Easterly and Levine emphasize the role of ethnic fragmentation and poor-quality institutions, while Sachs and Warner stress closed trade policies and geography as significant growth handicaps for Africa.

Here I focus on growth regressions limited to a Sub-Saharan sample of countries. An important motivation for restricting the sample in this way is the widespread feeling in Africa that the region is structurally so different from the rest of the world that global comparisons based cross-regional data are not particularly meaningful. Indeed many African policy makers believe the lessons from East Asia or Latin America do not apply to them because the circumstances differ so much. But African countries surely can learn from each other, and an empirical approach that focuses on performance within the continent has greater credibility for that reason.

My basic conclusion is that a small number of fundamentals determine the bulk of the cross-national variation in long-term growth performance within Africa. These fundamentals are human resources, macroeconomic/fiscal policy (especially the ability to manage resource

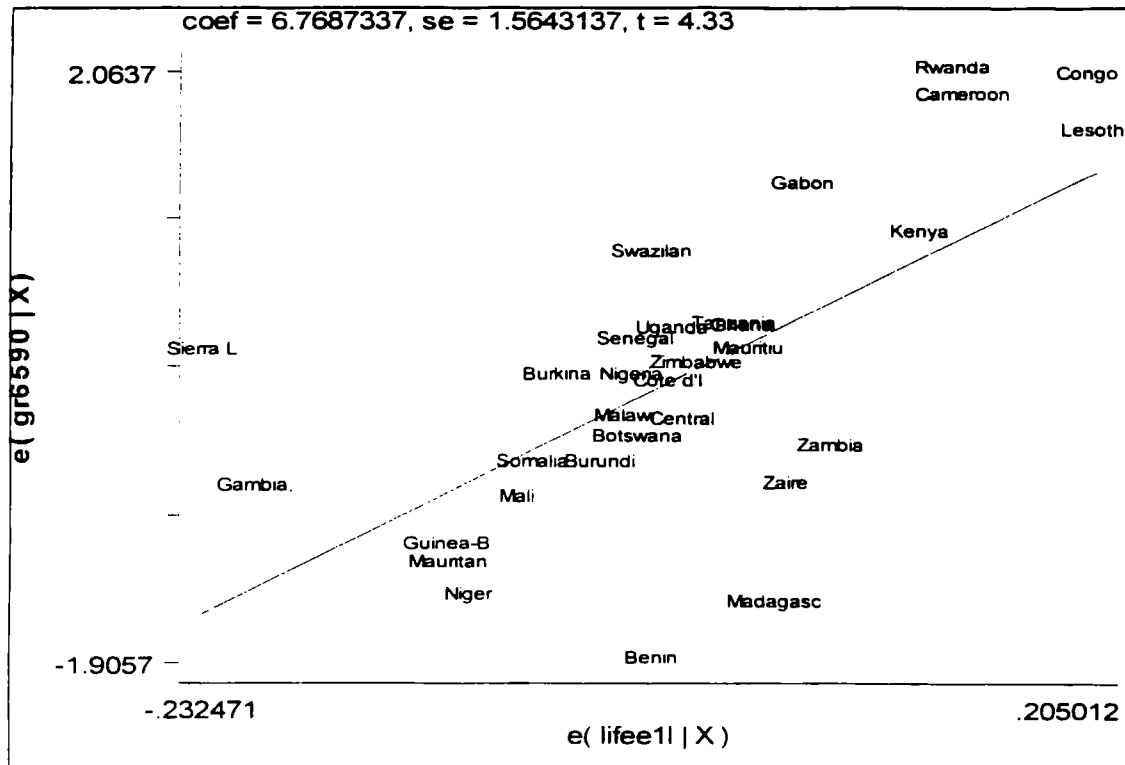
booms), demography, and a conditional convergence factor. These variables “explain” about 80 percent of the growth variation in Africa over the 1965-90 period (Rodrik 1997b). I find that trade policies do not play a significant role in growth, either in the medium-run or the long-run. However, excessive levels of export taxation are an important contributor to the relative decline of a few countries (namely Uganda, Burundi, and Ghana). Partial scatter plots relating these variables to growth are shown in Figures 5.5-5.8. Movements in the external terms of trade are only weakly correlated with growth performance over the long-run, but as discussed below, they play a more important role in the medium-run (of ten years or so).

In Table 5.5, I present panel regressions where decade averages of per-capita growth rates for the same three sub-periods as before are regressed on their determinants. These regressions give a sense of the determinants of growth over the medium-run (a decade), as opposed to the long-run. The fit of these regressions is significantly worse than those for the long-run cross-sections, with an R^2 of 0.33-0.38. In particular, export taxation and demography are no longer statistically significant. Public savings and life expectancy (proxying for macroeconomic balance and human resources, respectively) remain significant. Changes in the terms of trade now enter with a highly significant coefficient, suggesting that this variable is an important determinant of growth over shorter horizons. The estimated coefficient suggests that a ten percent improvement in the terms of trade per annum over a decade raises the annual average growth rate over the decade by 1.7 percentage points.

The final column of Table 5.5 provides some evidence that membership in the CFA zone has had asymmetric effects on growth in different periods. When a dummy for CFA membership is interacted with the dummy for the 1975-84 period (*cfa2*), the estimated coefficient is positive and borderline significant at the 95 percent level. But when the CFA

Figure 5.5

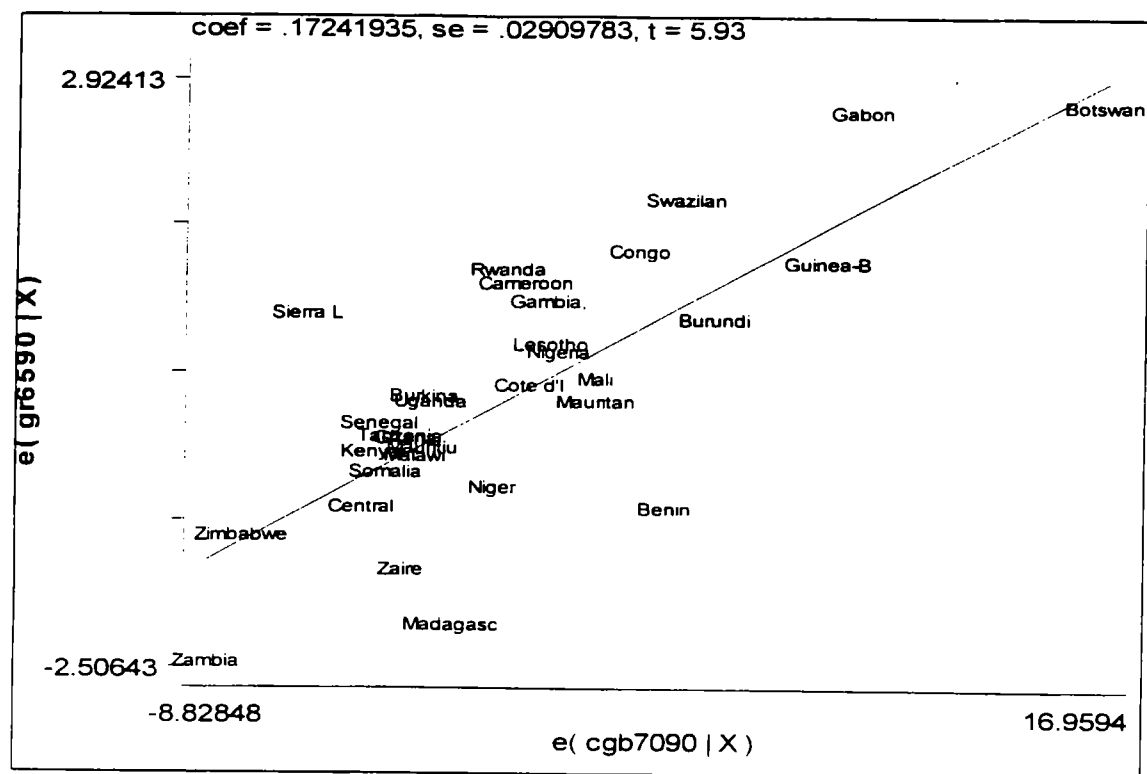
Partial scatter plot of growth against life expectancy



Notes: The variable on the vertical axis is the (unexplained part of the) growth rate during 1965-90. The variable on the horizontal axis is the component of the relevant explanatory variable that is orthogonal to the other explanatory variables. The variable "life1l" is the log of life expectancy in 1965.

Figure 5.6

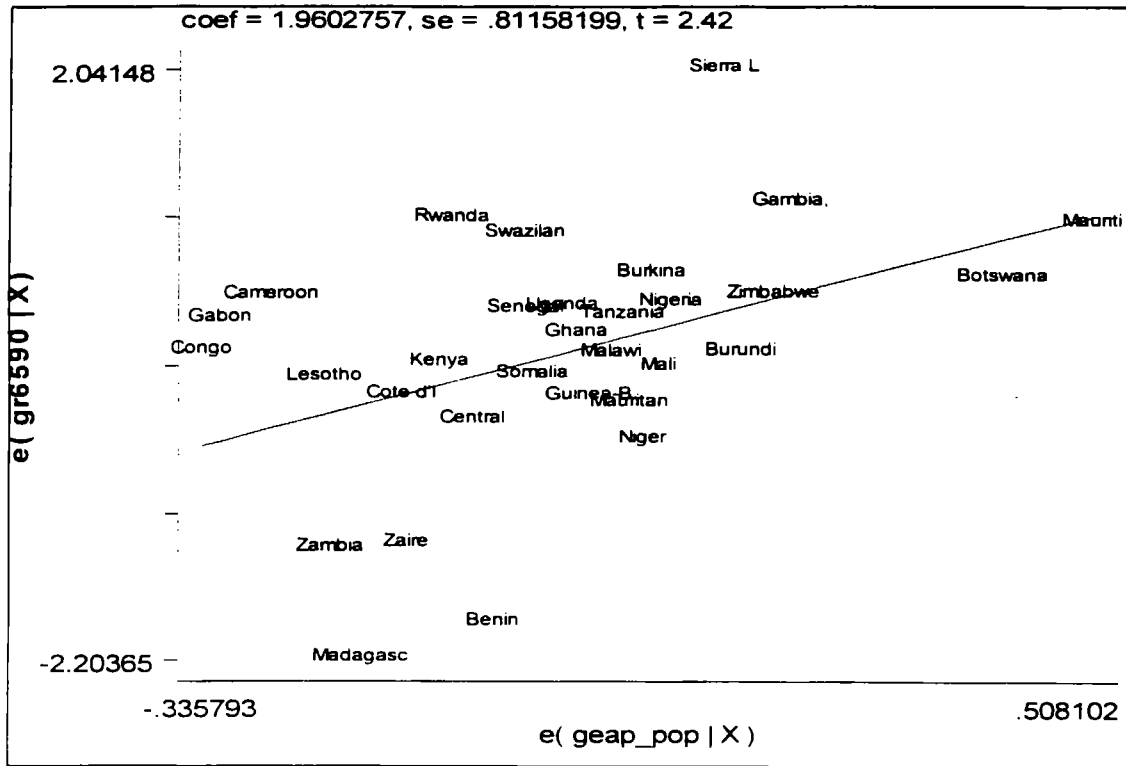
Partial scatter plot of growth against public savings



Notes: The variable on the vertical axis is the (unexplained part of the) growth rate during 1965-90. The variable on the horizontal axis is the component of the relevant explanatory variable that is orthogonal to the other explanatory variables. The variable "cgb7090" is the central government budget surplus averaged over 1970-90.

Figure 5.7

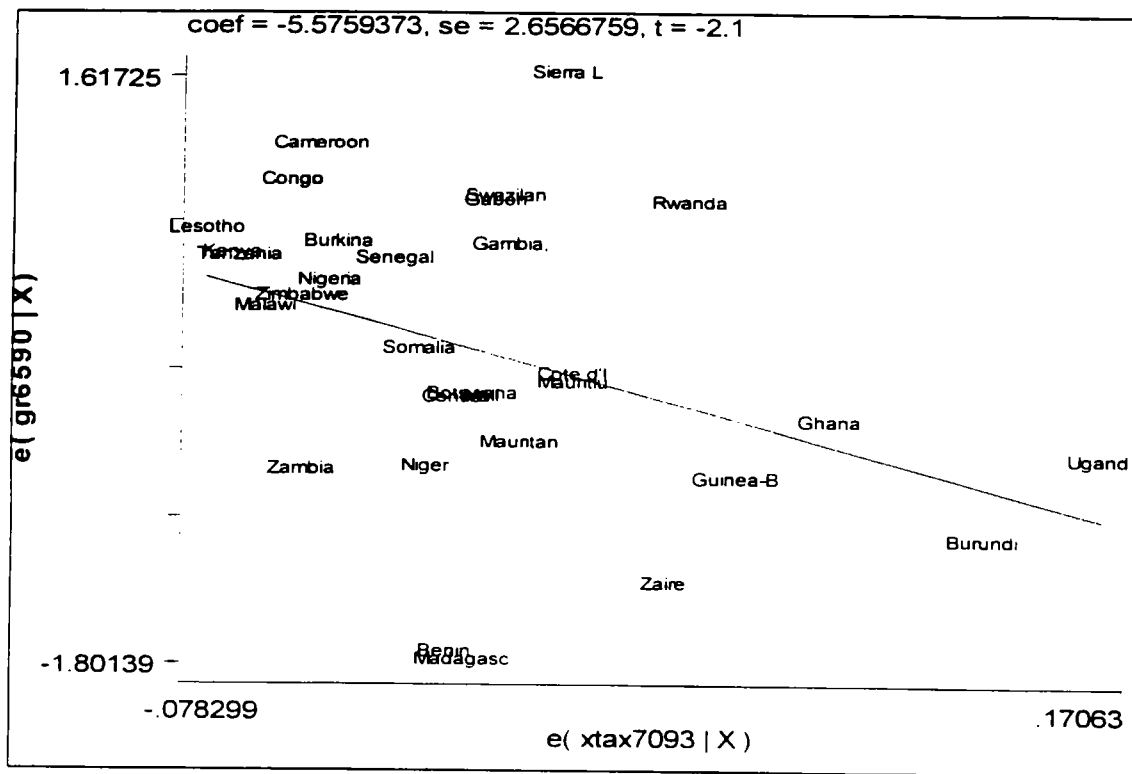
Partial scatter plot of growth against growth of economically active population relative to general population



Notes: The variable on the vertical axis is the (unexplained part of the) growth rate during 1965-90. The variable on the horizontal axis is the component of the relevant explanatory variable that is orthogonal to the other explanatory variables. The variable "geap_pop" is the growth rate of the economically active population relative to the total population.

Figure 5.8

Partial scatter plot of growth against export taxation



Notes: The variable on the vertical axis is the (unexplained part of the) growth rate during 1965-90. The variable on the horizontal axis is the component of the relevant explanatory variable that is orthogonal to the other explanatory variables. The variable "xtax7093" is the average rate of export duties during 1970-93.

Table 5.5

Growth regressions				
	dependent variable: per-capita GDP growth			
	(1)	(2)	(3)	(6)
<i>export taxes</i>	-1.65 (3.07)			
<i>log initial GDP per capita</i>	-1.13*** (0.65)	-1.44* (0.45)	-1.61* (0.48)	-1.42* (0.46)
<i>life expectancy</i>	0.16* (0.05)	0.19* (0.04)	0.14* (0.04)	0.19* (0.04)
<i>public savings (x100)</i>	0.12** (0.06)			
<i>growth of econ active pop (relative to total)</i>	0.30 (0.85)			
<i>terms-of-trade growth</i>		0.17* (0.06)	0.17* (0.07)	0.18* (0.06)
<i>botswana</i>			3.35** (1.64)	
<i>mauritius</i>			2.31 (1.80)	
<i>cfa2</i>				2.33*** (1.21)
<i>cfa3</i>				-1.72*** (1.01)
N	78	115	115	115
R ²	0.33	0.34	0.38	0.38
Root MSE	0.03	0.02	0.02	0.02

Note: Period dummies included (coefficients not shown). Robust standard errors are reported in parenthesis. Levels of statistical significance are as follows:

* 99% level
 ** 95% level
 *** 90% level

dummy is interacted with the dummy for 1985-94 (*cfa3*), the result is a negative coefficient that is significant at the 90 percent level. Hence CFA membership increased growth in the earlier period (by an average of 2.3 percent per annum), but decreased it in the later period (by an average of 1.7 percent). The interpretation is that the fixed exchange rate arrangement, and the price stability to which it gave rise, was an advantage when the underlying external balances were sustainable, but became a hindrance when devaluations were called for later.

Country experiences⁵⁷

Botswana

Botswana is an economy that has benefited greatly from openness. Its phenomenal economic performance has been based on diamond exports. But since natural resources in and of themselves are not always a blessing, as too many African countries have discovered, there is much more to this success story than diamonds. As the growth regressions discussed above suggest, the proximate determinants of Botswana's distinctive performance are prudent fiscal and macroeconomic policies, relatively well-developed human resources, and an early demographic transition which reduced the dependency ratio. These factors have enabled a sharp increase in investment rates in the early 1970s (mainly in mining). But also noteworthy is that the government has managed the diamond boom extremely well: resources have not been wasted, and temporary reversals in export receipts (as in 1981 and 1982) have been met with quick adjustments in the exchange rate and in fiscal policy.

Superior governance in macroeconomic management has apparently been matched in other fields as well. As mentioned before, Botswana is one of Africa's few continuous

democracies. The bureaucracy is honest and competent, attaches great value to economic expertise, and has consistently produced sensible macroeconomic policies. There has been no large-scale urban bias and no white elephants (Harvey 1992, 348). However, the government's philosophy has been far from laissez-faire. Government expenditures stood above 50 percent of GDP by the early 1990s, one of the highest levels in the world. Spending on public investment, subsidies, and other economic functions has made up between 40 and 50 percent of these expenditures. As a result, as Harvey (1992, 339) notes, "[t]here were enormous improvements in the provision of health and education, in the building of infrastructure and in other government services." What has distinguished economic interventions in Botswana is the quality, not quantity of the interventions.

Why this has been so is not altogether clear. As in Mauritius, the initial conditions were not favorable. When it became independent in 1966, Botswana was one of the poorest countries in the world, lacking a capital city and an educational base, and having only a few miles of paved roads (Harvey 1992, 338). Furthermore, Botswana has been virtually surrounded with warfare and violence, as a consequence of wars of independence in Angola, Zimbabwe, and Namibia, and the struggle in South Africa.

One explanation that is often advanced is the rural origin of the political leadership.

Harvey, for example, emphasizes the

strong influence of rural exporters on economic policy. A large majority of politicians and senior government officials in Botswana own cattle, and an even higher proportion are related to people who own cattle. The income from cattle comes mostly from exporting. (Harvey 1992, 360-1)

This, it is argued, explains why policies in Botswana have not been anti-export, and why the economy has never been allowed to succumb to the Dutch disease.

⁵⁷ This section is based on Rodrik (1997b) and (1998a).

An alternative hypothesis focuses on the external constraints on trade policy. Along with Lesotho, Swaziland, and South Africa, Botswana has long been a member of the Southern Africa Customs Union (SACU). This means that Botswana has no independent trade policy: goods circulate freely between it and South Africa. The government gets a share of customs revenue collected by South Africa, which amounts to around 20 percent of the value of Botswana's imports, which is high. What matters from our perspective is that government officials have no control over this revenue on a day-to-day basis: nor do they have an ability to interfere with the flow of goods from South Africa. More to the point, domestic producers in the urban areas know that this is so, and therefore realize that lobbying policy makers for favors in the trade arena is futile. We can think of the absence of an independent trade policy as an extreme form of an "agency of restraint" (Collier 1995).⁵⁸

Could this externally-imposed free trade regime be a key reason for Botswana's success on the economic front? Obviously, the government's ability to tax exports, either directly or indirectly, was sharply restricted. But beyond that, the absence of an import-substituting urban lobby—ensured by the free-trade regime—could have led to improved governance on other fronts as well. For example, the admirable manner in which the government responded to a large drop in diamond earnings in 1981, by swiftly devaluing the currency and avoiding exchange controls (see Lewis 1992, 19ff), may have been enabled by the absence of entrenched urban interests. Protected behind non-tariff barriers, these urban groups would have welcomed such

⁵⁸As a small country in SACU, Botswana was essentially forced to inherit South Africa's relative price structure. Its gains from trade derived from the difference between this relative-price structure and that which would have obtained under autarky in Botswana. The fact that the external tariffs in SACU were fairly high—and that South Africa's relative structure was distorted relative to the rest of the world—is largely irrelevant to the existence of gains from trade for Botswana. However, to the extent that the external tariffs in SACU pushed South Africa's relative prices in the direction of Botswana's autarky price ratio, these external tariffs reduced Botswana's gains from trade (relative to free trade outside the SACU structure).

controls and other trade restrictions, and would have made it more difficult for the government to undertake the requisite policy adjustments. In any case, that was the typical experience in the rest of Africa and Latin America, where the governments responded to external shocks by tightening restrictions and delaying macroeconomic adjustments.

Therefore, one interpretation of Botswana's experience is that governance was improved not only by democracy but also by the absence of an administered trade regime. In this case, imported institutions seem to have helped.

Reform and recovery: Ghana and Uganda

These two countries have undertaken a broad range of reforms during the 1980s, including extensive trade liberalization, after a prolonged period of economic decline.⁵⁰ In both countries, all major economic indicators had sunk to distressingly low levels by the early 1980s, and for both, the culprit was gross mismanagement of the economy, aggravated by civil war in the case of Uganda during 1985-86.

Extensive trade reforms began in Ghana in 1983, and in Uganda in 1987. Prior to these dates, the trade regime in each country was characterized by a plethora of trade control instruments: high tariffs, stringent QRs, export restrictions, foreign-exchange restrictions, and a high black-market premium. In both countries, the reforms initially focused on removing the extreme distortions in the market for foreign exchange. In Ghana there were three devaluations over a three-year period and a steady, if slow, reduction in the gap between the official and parallel market rate. An auction market for foreign exchange was introduced in 1986, and the unification of the exchange rate was finally accomplished the following year. In Uganda,

following an initial 77% devaluation in 1987, the shilling was adjusted periodically throughout 1989 and the parallel-market premium steadily declined. Foreign exchange bureaus were licensed in 1990, further narrowing the spread between the parallel and official markets. Finally, at the end of 1993, the exchange system was unified with the introduction of an interbank system.

With regard to QRs, the introduction of a new licensing system in Ghana in 1986 allowed the importation of non-consumer goods without restriction. Import licensing was streamlined by moving from a positive to a short negative list. In 1989, import licensing and prohibitions were fully terminated. In Uganda, import liberalization was fairly rapid, beginning with the open general licensing scheme (OGL) in 1987, which focused on allocating foreign exchange for the importation of raw materials on a “nondiscriminatory” basis. The list of eligible firms was expanded periodically throughout 1990. By 1993, the OGL scheme was phased out and replaced with a short negative list.

In both countries there were several rounds of tariff reforms, some aimed at rationalizing the tariff structure and others (especially in Ghana) aimed at making up for some of the protection lost through the reform of the QRs. Overall, the ranges of tariffs and their dispersion have been greatly reduced.

On the export side, Uganda has gone farther, by removing the monopoly of the coffee marketing board and abolishing all export taxes (including the tax on coffee, which was reintroduced in 1994 following a rise in world prices). Ghana has reduced the taxation of cocoa exports, but the government retains its export monopoly.

⁵⁰ This account relies on the following sources: Dean et al. (1994), Tutu and Oduro (1996), Hadjimichael et al. (1996), Ssemogerere (1997), World Bank (1996a and b), and WTO (1995b).

There can be little doubt that these reforms, along with better macroeconomic management and external financial support, have helped Ghana and Uganda recover. Both countries are growing after a long stretch of decline. Exports are up in both countries, and in the case of Ghana the export-GDP ratio exceeds the level reached in 1970, even though per-capita GDP still falls short of the 1970 level. Investment is up as well, but is apparently led primarily by public investment. At the same time, it is evident that even after a decade or more of reform, there remains some doubt about the long-run performance of the two economies. Neither has yet caught up with the level of per-capita income reached in 1970. It is too early to declare victory.

Reform without growth: Mali and the Gambia

Mali and Gambia provide an interesting contrast to the experience of Ghana and Uganda. Both economies are now substantially open to external trade.⁶⁰ However, they have yet to reap significant gains on the growth front, partly due to extremely poor human and physical resources, and their growth potential is correspondingly low. Another factor is that their reforms did not come after a protracted period of decline, at least of the order of magnitude experienced by Ghana and Uganda, and therefore they have not had the benefit of a bounce back in economic activity.

Mali began its trade reforms in 1986 by eliminating export monopolies. In 1988, the reforms were significantly strengthened with quota liberalization and abolition of import monopolies. In 1990, all QRs and import licensing requirements were abolished, and the following year import tariffs were reduced to a range of 6-41%. Until the devaluation of the

⁶⁰ This account is based on World Bank (1996b), Dean et al. (1994), Hadjimichael et al. (1992), Radelet (1993), and Sahn (1994).

CFA franc in January 1994, however, the economy was stuck with an uncompetitive exchange rate. There are signs of economic revival since the devaluation.

The Gambia has traditionally been an open economy, free of import quotas and other trade restrictions in the importation or exportation of any good other than groundnuts (Hadjimichael et al. 1992). Facing a payments crisis, the government launched a macroeconomic stabilization and adjustment program in mid-1985. The key components of the program were the liberalization of the exchange rate, increases in the prices of traded goods, particularly for groundnuts, and the elimination of government subsidies. Tariffs were rationalized and the average duty rate was reduced. In 1990, the state export monopoly for groundnuts was eliminated and farmers and traders were allowed to sell groundnuts to anyone willing to buy.

Hence, there has been substantial trade reform in both countries, perhaps more so than in Ghana and Uganda. But there is little indication that either economy has been greatly boosted by these measures. In both countries, export ratios have generally increased following the reforms, but the impact on economic growth has been modest at best. These cases support the finding from the cross-national regressions: trade policy has strong and predictable effects on trade volumes, but it is an unreliable instrument for generating economic growth.

Concluding remarks

The turbulence experienced in world markets since the mid-1970s had severe adverse effects on both Latin America and Africa. The upshot in Latin America was the wholesale adoption by virtually all governments in the region of orthodox recipes—namely fiscal retrenchment, deregulation, free trade, and privatization. In Sub-Saharan Africa, free-market religion has found far fewer converts. Despite tremendous pressure from donor governments and

multilateral agencies. African policy makers have generally been more skeptical about the value of opening up their economies and reducing the role of government. Consequently, reforms have progressed rather gradually and have been full of interruptions and reversals. The contrast with Latin America, where governments have stuck with ambitious reforms even under severe macroeconomic difficulties—for example during the Mexican peso crisis of 1995—is quite striking.

There is a fair bit of consensus on what constitutes a reasonable trade strategy for African countries. The consensus can be crudely expressed in terms of a number of do's and don't's: de-monopolize trade; streamline the import regime, reduce red tape, and implement transparent customs procedures; replace quantitative restrictions with tariffs; avoid extreme variation in tariff rates and excessively high rates of effective protection; allow exporters duty-free access to imported inputs; refrain from large doses of anti-export bias; do not tax export crops too highly. Provided that the qualifiers in the previous sentence ("extreme," "excessively high," etc.) are interpreted reasonably, these desiderata do remain useful. They also leave considerable room for policy makers to make their own choices over a wide range of trade and industrial-policy options. To take one example: an African country with average tariffs of 35 percent will have made a very different choice than one with average tariffs of 5 percent; yet both countries would be regarded as having an "open" trade regime according to Sachs and Warner's (1995) influential measure of openness.⁶¹

Some aggressive reformers like Ghana and Uganda (and Mauritius before them) have implemented most, but not all, of the above agenda. Many other countries have done much less.

⁶¹ Sachs and Warner (1995) set their cut-off level for "openness" at 40 percent where average tariffs are concerned. Their measure of openness relies on four other indicators besides tariffs.

Part of the reticence among African policy makers is due to the suspicion that trade reform may not “work” in Sub-Saharan Africa, at least the way it “worked” in East Asia and more recently in some cases in Latin America.

I argued in this chapter that there is little ground for pessimism in this regard. The evidence indicates that the cross-national variation in trade performance within the region is well-explained by the standard determinants of trade, namely trade policies, income levels, country size, and geography. In particular, trade policies, as measured by taxation of imports and exports, are significantly and robustly correlated with volumes of trade as well as the growth of trade. Removal of these impediment on trade can be expected to have a major impact on trade volumes.

However, a second theme is that commercial policy reforms have only weak links to economic growth. The variation in long-term growth performance within the region is explained largely by investment rates, human resources, fiscal policy, demography, and a catch-up factor. The external terms-of-trade have also played a role over shorter horizons. Trade policies have played a much smaller role in growth performance, although there is evidence that excessive taxation of exports was partly responsible for some dismal failures.

I have shown that the marginalization of Africa in world trade is entirely due to the slow growth of African economies. Taken as a whole, the region participates in international trade as much as can be expected according to international benchmarks relating trade volumes to income levels, country size, and geography.

The two most successful countries in the region, Botswana and Mauritius, have combined elements of an open economy with more unorthodox policies in other spheres. As a member of SACU, Botswana has not had an independent trade policy, a factor which may have been crucial

in achieving good governance on macroeconomic and other fronts. But it has also had a very large public sector and extensive government involvement in the economy. As I discussed in chapter 3, Mauritius has followed a two-track strategy until the 1980s, with an export processing zone operating on free-trade principles functioning side by side with a highly protected domestic economy. These two countries illustrate the argument that, in Helleiner's (1997, 37) words, "African governments need not succumb to 'mindless globalization' via their total abandonment of any role in the mediation of national links to the world economy."

Successful instances like Botswana and Mauritius notwithstanding, trade reform in Africa has generally been erratic and marked by reversals and lack of credibility. At the heart of these difficulties lie the sharp distributional consequences of trade reform. The fault lines here not only exist between the rural sector (the likely beneficiary of the removal of export restrictions) and the urban sector, but also between the public sector (where bureaucratic privileges and rents reside) and the private sector. Managing these distributional issues is tricky, yet crucial to successful reform (Rodrik 1998a).

It is clear that Sub-Saharan African countries are able to grow at rapid rates when the circumstances are right. Trade volumes are responsive to prices, and countries where exports of traditional and non-traditional products have been sharply discouraged by taxes and other restrictions can expect a solid payoff in terms of trade volumes when such policies are removed. There is no evidence that African trade has been significantly affected by external developments. And there is little ground for concern in general that the structure of African economies makes them unsuitable for the application of remedies that have worked in other settings.

At the same time, there are clear limitations to what trade policy, or outward orientation, can accomplish. Growth depends first and foremost on the fundamentals identified above.

Investments in human resources and infrastructure and establishing the credibility of the institutions of macroeconomic management are going to take time. So will the demographic transition. Opening an economy to international trade is not a quick fix that can substitute for these harder tasks. As suggested in the introduction, an excessive emphasis on trade liberalization can backfire if it diverts the scarce energies and political resources of government leaders from growth fundamentals. The benefits of trade reform should not be oversold. Economic policy should focus on growth, not on trade.

Chapter 6: Summary and Implications

A modern-day morality tale

Imagine that a Martian lands in Washington and is captured by a group of mischievous economists. The economists make a deal with her. They will release her if she can prove her intelligence by coming up with the correct answer to an economics question. The question is the following: Which government policies are most likely to predict how well different countries did over the last two decades? To make the deal fair, the economists agree to provide the Martian with a briefing book containing a set of readings drawn from the current literature on trade and development. After this crash course on contemporary economic thought, the Martian provides her answer. The countries that grew most rapidly, she replies, were countries with low tariffs, few non-tariff barriers, and no restrictions on international capital flows. The economists look at each other and realize they have no choice but to release her. They conclude that intelligent life exists outside planet earth.

Bit by the economics bug, the Martian decides to learn a bit more before returning home. She reads up on statistics and gets a hold of some cross-national data. She calculates the correlation coefficients between various indicators of trade policy and growth of GDP per capita across countries. But the results are puzzling. None of the indicators of policy towards trade and capital flows that she can lay her hands on—average tariff levels, non-tariff coverage ratios, or indices of capital-account liberalization—are statistically significantly correlated with per-capita GDP growth.⁶² Either economics is a lot more complicated than she sensed, or else humans are

⁶² The Martian is smart enough to realize that richer countries—regardless of their growth rates—have fewer restrictions on trade in goods and capital, and she controls for that.

not nearly as intelligent as they seem. In either case, she figures it is best to leave planet earth before her captors change their minds.

The promise and perils of openness

For policy-makers all around the world the appeal of opening up to global markets is based on a simple, but powerful promise: international economic integration will improve economic performance. As countries reduce their tariff and non-tariff barriers to trade and open up to international capital flows, the expectation is that economic growth will increase. This in turn will reduce poverty and improve the quality of life for the vast majority of the residents of developing nations.

The trouble, as the Martian has discovered, is that there is no convincing evidence that openness, in the sense of low barriers to trade and capital flows, systematically produces these consequences. In practice the links between openness and economic growth tend to be weak, and contingent on the existence of complementary policies and institutions. As I emphasized in chapter 2, the benefits of openness lie on the import side: the ability to import ideas, investment goods, and intermediate inputs from more advanced countries can significantly boost economic growth. But to realize this potential, developing nations need other things too. They need to create an environment that is conducive to private investment—to follow what I have called an investment strategy. They need to improve their institutions of conflict management—civil liberties and political freedoms, social partnerships, and social insurance—so they can maintain macroeconomic stability and adjust to rapid changes in external circumstances. In the absence of these complements to a strategy of external liberalization, openness will not yield much. At worst, it will be a source of instability, widening inequalities, and social conflict.

The evidence from the experience of the last two decades is quite clear: the countries that have grown most rapidly since the mid-1970s are those that have invested a high share of GDP and maintained macroeconomic stability. This is the bottom line of the cross-national econometric exercise summarized in Table 6.1. The exercise is the type of effort that the Martian might have undertaken with a bit more knowledge and time on her hands. Her findings with regard to the relative insignificance of trade policy, however, would remain unchanged.

The table shows the consequences of regressing per-capita GDP growth over the 1975-94 period on initial income, initial education levels, regional dummies, and additional explanatory variables. As the table shows, there is only a weak correlation over this period between economic growth and indicators of openness. Whether based on tariff and non-tariff restrictions or on trade volumes, none of the measures of trade openness exhibits a statistically significant relationship with growth (columns 5, 6, and 7).⁶³ Openness to capital flows—captured by an indicator of capital-account liberalization—does not exert any influence either (column 8). Neither is the size of government a significant factor (columns 9 and 10). What matters most are investment rates (columns 2 and 3) and macroeconomic stability (column 4).

The scatter plots in Figures 6.1-6.5 give a visual sense of these results. They show the relationship between economic growth and some of these policy variables, after the effects of other influences (initial income, education, and regional dummies) are taken out. The weakness of the association between indicators of openness and economic growth is evident in the scatter

⁶³ It bears repeating the reasons why this finding departs from the conventional wisdom, especially since conventional wisdom appears to be grounded in a large number of empirical studies. One reason is that many of the leading studies confound the trade regime with an economy's macroeconomic stability by using measures that are based on black-market premia or exchange rates. When more appropriate indicators, i.e., tariff and non-tariff barriers to trade, are substituted for these hybrid measures, the strong results typically vanish. A second reason is that some studies use measures of openness that are based on actual volumes of trade or foreign investment. The results from these studies are uninformative on the role of openness because countries that grow fast also tend to experience rapid growth in trade and are more attractive to foreign investors.

Table 6.1

Determinants of per-capita GDP growth, 1975-94

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Latin America	-0.016*	-0.014*	-0.014*	-0.011*	-0.018*	-0.018*	-0.018*	-0.016*	-0.017*	-0.015**
	(0.004)	(0.004)	(0.004)	(0.003)	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)	(0.006)
East Asia	0.024*	0.021*	0.020**	0.021*	0.016***	0.024*	0.022*	0.021**	0.022*	0.017***
	(0.008)	(0.007)	(0.008)	(0.008)	(0.009)	(0.008)	(0.008)	(0.009)	(0.007)	(0.009)
Sub-Saharan Africa	-0.017*	-0.017*	-0.016**	-0.018*	-0.021*	-0.024*	-0.024*	-0.017*	-0.017*	-0.021*
	(0.006)	(0.006)	(0.006)	(0.005)	(0.006)	(0.005)	(0.005)	(0.006)	(0.006)	(0.007)
log per-capita GDP, 1975	-0.003	-0.004***	-0.005***	-0.006***	-0.005	-0.006***	-0.006***	-0.003	-0.004	-0.004
	(0.003)	(0.003)	(0.003)	(0.003)	(0.004)	(0.003)	(0.003)	(0.003)	(0.003)	(0.003)
log secondary enrolment, 1975	0.005***	0.006**	0.007**	0.006**	0.005***	0.008*	0.007**	0.005***	0.005***	0.004
	(0.003)	(0.003)	(0.003)	(0.002)	(0.003)	(0.003)	(0.003)	(0.003)	(0.003)	(0.002)
<u>investment</u>										
investment/GDP, 1975-94		0.095*								
		(0.025)								
excluding Lesotho ^a			0.110**							
			(0.050)							
<u>macroeconomic stability</u>										
index of macro mismanagement ^b				-0.026*						
				(0.007)						
<u>openness</u>										
average tariff rate ^c (x100)					-0.024					
					(0.031)					
NTB coverage ratio ^c						-0.009				
						(0.009)				
trade ^d							0.000			
							(0.000)			
capital-account liberalization ^e								0.002		
								(0.005)		
<u>government size</u>										
government consumption/GDP									-0.040	
									(0.025)	
total govt exp /GDP										-0.011
										(0.021)
N	91	84	83	83	82	73	73	90	91	76
R ²	0.45	0.56	0.56	0.53	0.42	0.61	0.59	0.43	0.47	0.40

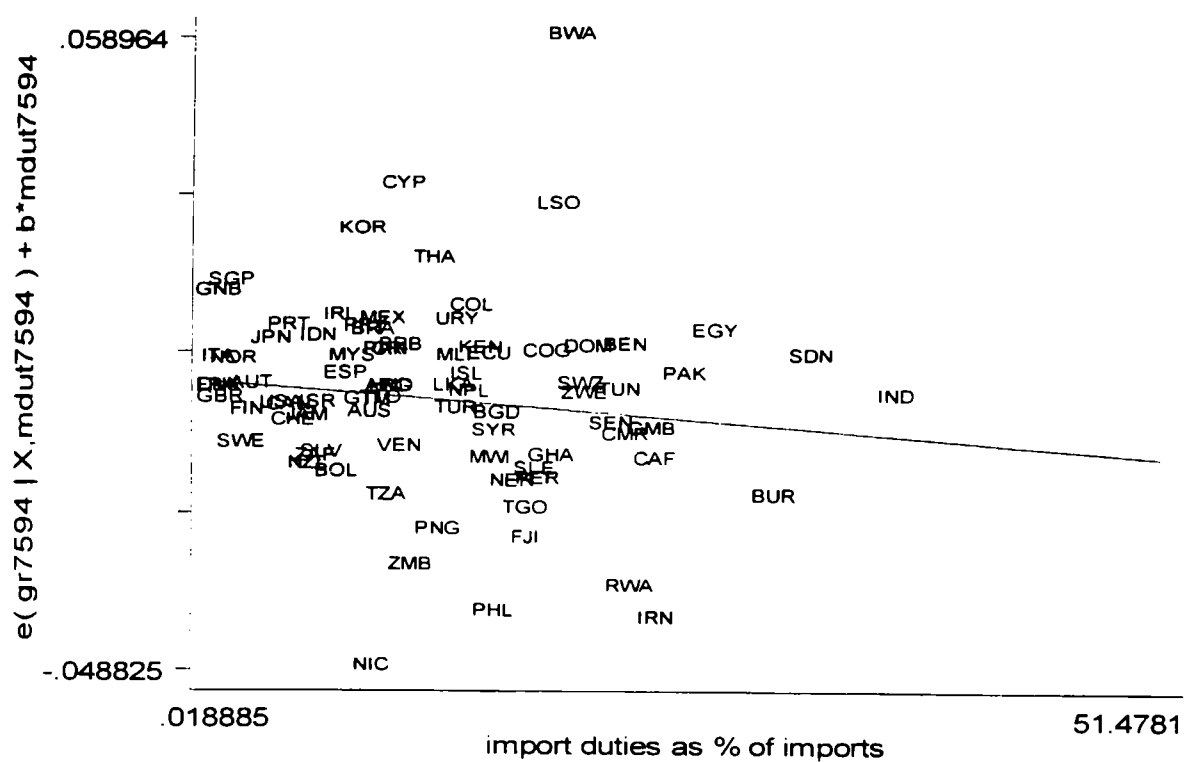
Table 6.1

Notes:

- a. This regression is run with and without Lesotho, as this country looks like an outlier that could distort the results.
- b. This index is constructed by taking a simple average of the inflation rate and (1 plus) the log black market premium during 1975-90.
- c. Sources: World Development Indicators 1998 (average import duty rate, 1975-94) and Barro and Lee (1994) for NTBs.
- d. The volume of trade in excess of the predicted volume, with the predicted values coming from a cross-country regression of trade on geographical determinants (population, distance from major trading partners, and regional dummies).
- e. The proportion of years during 1975-94 without restrictions on the capital account, as coded by Kim (1997) from IMF sources.

Figure 6.1

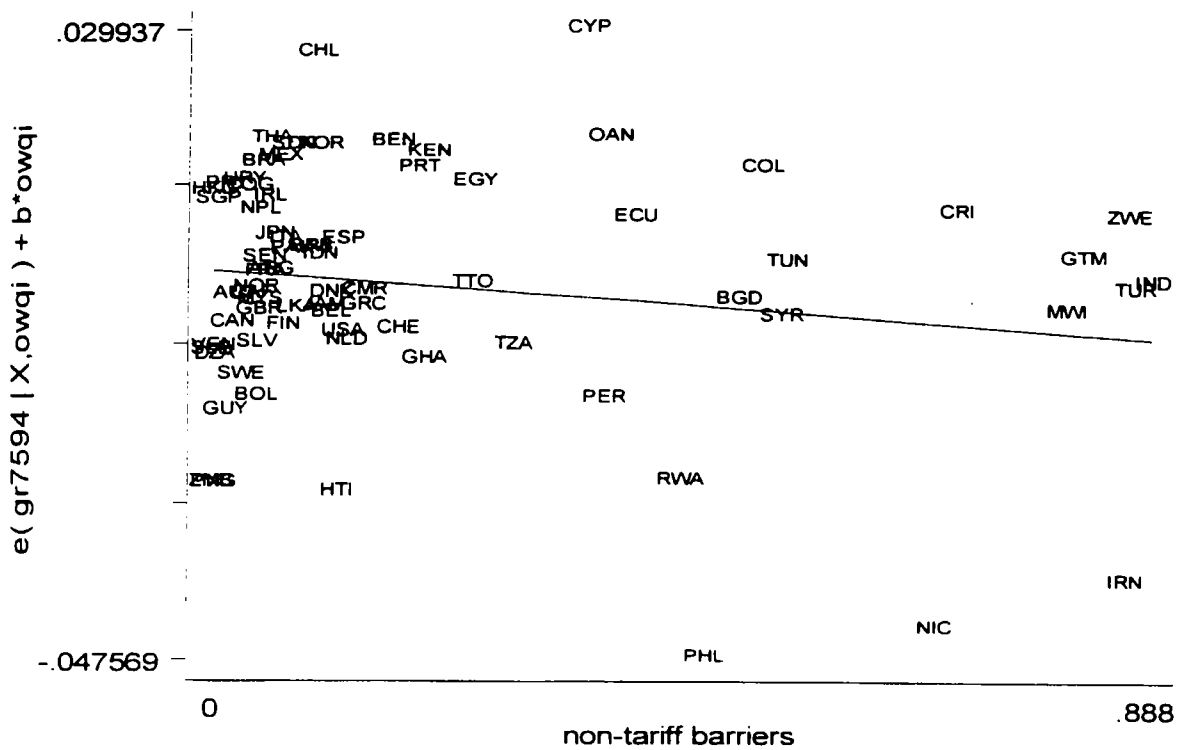
Relationship between growth and import tariffs, 1975-94



Notes: The variable on the vertical axis is the (unexplained part of the) per-capita growth rate during 1975-94.

Figure 6.2

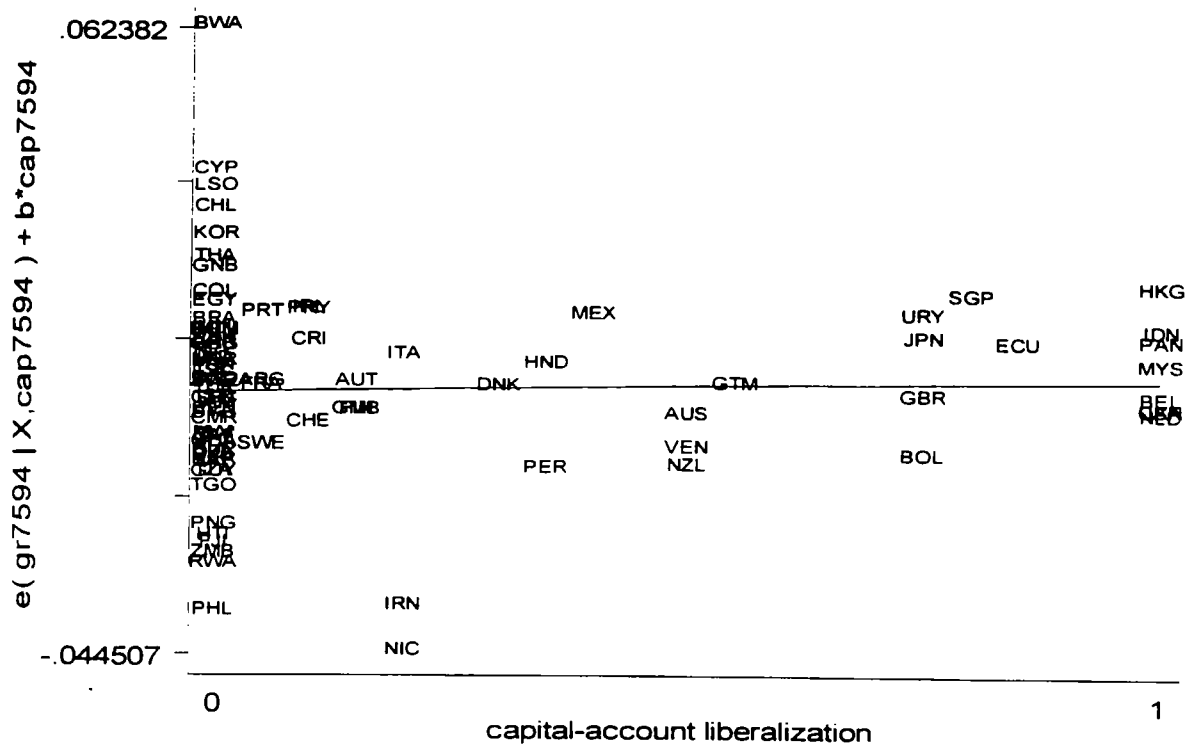
Relationship between growth and non-tariff barriers to trade, 1975-94



Note: Same as Figure 6.1.

Figure 6.3

Relationship between growth and capital-account liberalization, 1975-94



Note: Same as Figure 6.1.

plots (Figures 6.1-6.3). To cite some instances: Pakistan and Egypt have done comparably well in their regions despite high average tariffs. Haiti has done very poorly despite low non-tariff barriers, and Bolivia has done dismally despite having an open capital account throughout most of this period. The relationship between growth and investment is much tighter, as is the relationship between growth and macroeconomic stability (Figures 6.4 and 6.5).⁶⁴

Such findings should caution policy makers against buying too readily into current development fashions. The evidence in favor of the small government/free trade orthodoxy is less than overwhelming. Investment and macroeconomic policies remain key. There is no magic pill to solve the challenges of economic growth—and if there is, openness is not it.

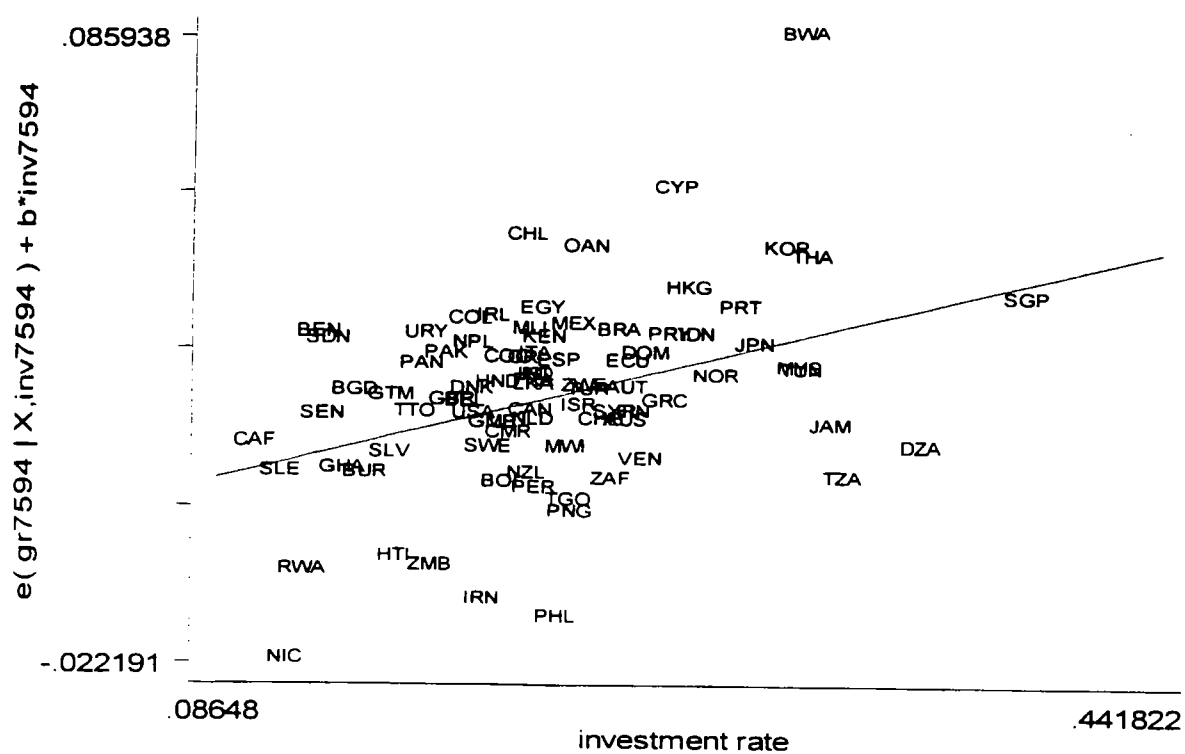
From a broader historical perspective, there should be nothing surprising about these conclusions and in particular about the argument that the relationship between trade barriers and economic performance is ambiguous. After all, most of the countries that successfully followed Britain into the industrial revolution did so under trade regimes that would have been classified as highly restrictive by today's standards. In the United States, to take a prominent example, import tariffs averaged around 40 percent in the half century following the Civil War, a period in which the U.S. caught up with and overtook Britain and the rest of Europe. To put this number in perspective, note that only one country in our sample (among those with data) had an average tariff rate during 1975-94 exceeding 40 percent (Seychelles)—although non-tariff barriers are of course more common these days than during the 19th century.⁶⁵ Neither history nor recent evidence provides support for a straightforward association between the level of trade barriers and long-term growth.

⁶⁴ See also Mosley (1998), which underscores many of the same findings, including the non-robust relationship between trade policy and growth and the insignificance of government size in long-run performance.

⁶⁵ On evidence that tariffs may have speeded up growth in late-19th century, see O'Rourke (1997).

Figure 6.4

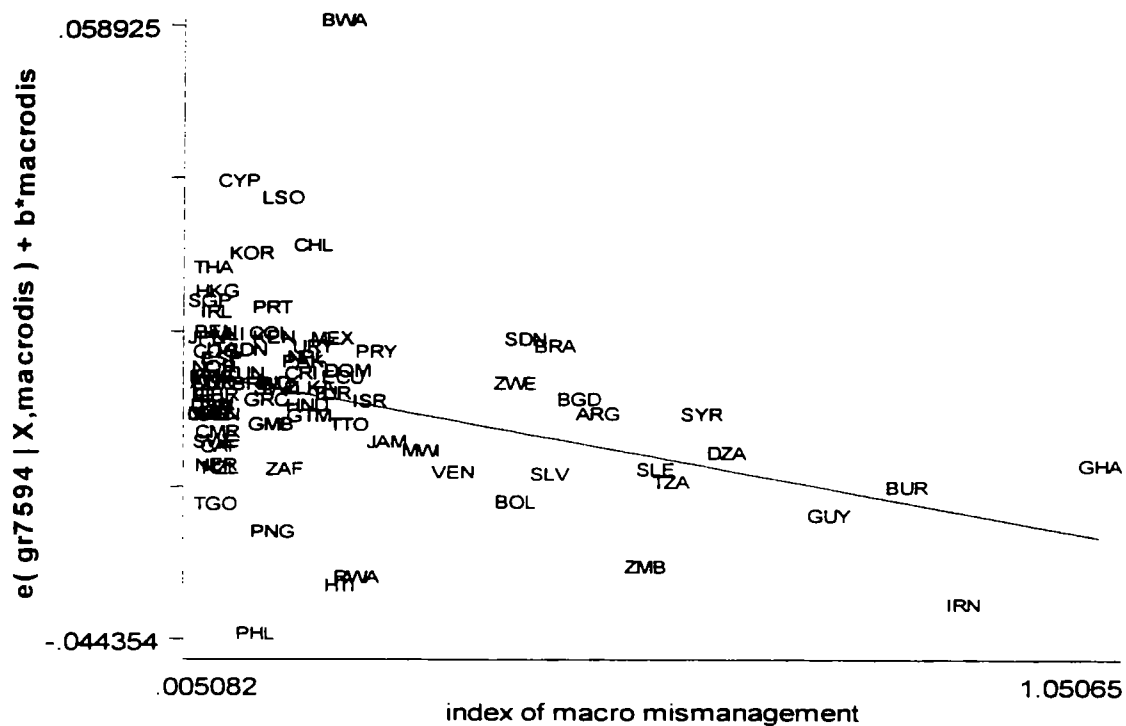
Relationship between growth and investment, 1975-94



Note. Same as Figure 6.1.

Figure 6.5

Relationship between growth and macroeconomic mismanagement, 1975-94



Note: Same as Figure 6.1.

How much do we really know about economic policies for sustainable growth?

In late 1997, South Korea became the latest victim of the Asian financial crisis. With foreign reserves in danger of depletion, the Korean government approached the IMF for help. To help stave off the crisis, the IMF organized a rescue package of \$57 billion from official sources, including \$21 billion of its own money. In return, the Korean government accepted an extensive program of reform that, carried to its fruition, would completely overhaul the structure and governance of the Korean economy. The program included:

- a comprehensive financial-sector restructuring, including independence of the central bank and the suspension of the operations of nine merchant banks;
- tight money policies, higher interest rates, and a fiscal retrenchment initially equivalent to about 2 percent of GDP (the latter requirement was subsequently relaxed as the real economy deteriorated more than anticipated);
- the dismantling of “nontransparent and inefficient ties among the government, banks, and businesses,” including the phasing out the system of cross guarantees within conglomerates;
- a program of trade liberalization, including the phasing out of trade-related subsidies, of restrictive import licensing, and of the import diversification program;
- capital-account liberalization, including the lifting of all capital-account restrictions on foreign investors’ access to the Korean bond market;
- labor-market reforms increasing flexibility.⁶⁶

⁶⁶ Information obtained from the IMF’s web site. See <http://www.imf.org/External/np/external/facts/asia.HTM> (Box 4) and <http://www.imf.org/external/np/oth/korea.htm>.

How appropriate were these measures? As Feldstein (1998) has argued, what Korea needed most at the time “was coordinated action by creditor banks to restructure its short-term debts, lengthening their maturity and providing additional temporary credits to help meet the interest obligations.” There is little reason to believe, as Feldstein emphasizes, that most of the structural changes imposed by the IMF on Korea were required for renewed access to capital markets:

Although many of the structural reforms that the IMF included in its early-December program for Korea would probably improve the long-term performance of the Korean economy, they are not needed for Korea to gain access to capital markets. They are also among the most politically sensitive issues: labor market rules, regulations of corporate structure and governance, government-business relations, and international trade. The specific policies that the IMF insists must be changed are not so different from those in the major countries of Europe: labor market rules that cause 12 percent unemployment, corporate ownership structures that give banks and governments controlling interests in industrial companies, state subsidies to inefficient and loss-making industries, and trade barriers that restrict Japanese auto imports to a trickle and block foreign purchases of industrial companies.

In effect, the financial crisis was treated as an opportunity to remold the Korean economy in the image of a free-market economy—or more correctly, a Washington economist’s idea of one.

That the IMF could get away with this—let’s remember that the Korean government enthusiastically latched on to most elements of the program—is indicative of a number of novel developments in the world economy. First, even the most successful countries in the world can be brought to their knees nowadays by sudden changes in market sentiment. Second, international institutions such as the IMF (and the U.S. government as their principal backer) can acquire tremendous leverage over the policies of smaller countries when the world economy turns sour. Third, global policy makers have come to place excessive confidence on a particular vision of what constitutes desirable economic policy. This neo-liberal model of the economy

emphasizes free trade and free markets, with the government's role limited to the provision of the rule of law, prudential regulation, and minimal social safety nets.

"Imposing detailed economic prescriptions on legitimate governments would remain questionable," Feldstein (1998) writes.

even if economists were unanimous about the best way to reform the countries' economic policies. In practice, however, there are substantial disagreements about what should be done. Even when there has been near unanimity about the appropriate economic policies, the consensus has changed radically. After all, the IMF was created to defend and manage a fixed exchange-rate system that is now regarded as economically inappropriate and practically unworkable. Similarly, for a long time the advice to developing countries that came from the World Bank, the IMF's sister institution, and from leading academic specialists emphasized national plans for government-managed industrial development. The official and very influential U.N. Economic Commission for Latin America preached the virtues of protectionist policies to block industrial imports in order to encourage countries to develop their own manufacturing industries. Now the consensus of professional economists and international agencies calls for the opposite policies: flexible exchange rates, market-determined economic development, and free trade... Even if it were desirable for Korea to shift toward labor, goods, and capital markets more like those of the United States, it may be best to evolve in that direction more gradually and with fewer shocks to existing businesses.

As Feldstein recognizes, the fact that fashions in economic policy change frequently should make us more humble in prescribing detailed structural programs on developing countries—especially on those that have grown rich by eschewing conventional wisdom and espousing heterodox policies. The reality is that our prescriptions often go way beyond what can be supported by careful theoretical reasoning or empirical demonstration. We know a lot less about what makes for good economic policy than we recognize.

As I have discussed throughout this book, the economies that have done well in the postwar period have all succeeded via their own particular brand of heterodox policies. Macroeconomic stability and high investment rates have been common, but beyond that many details differ. This too should be a warning against trying to fit all developing nations into a straitjacket of policies that have only recently become conventional wisdom.

International constraints on national policy

But do developing countries really have a choice? Can small nations still pursue their own distinctive agendas and govern their economies in ways that differ from the prevailing precepts? To hear many policy makers speak, the answer is no. It has become a common refrain to say that there is little choice but to privatize, open up, and attract DFI.

As I have argued before, exports and DFI are a means to an end, not an end in themselves. Gearing economic policy towards performance in the external sectors of the economy, at the expense of other objectives, amounts to mixing up the ends and the means of economic policy. Furthermore, there is nothing more conducive to trade and DFI than high economic growth itself. Foreign investors care little about Botswana's huge public sector, and neither are they much deterred by Chinese-style socialism. Policies that are successful in igniting growth are also likely to pay off in terms of "international competitiveness."

As I have argued above, external constraints can sometimes be useful in fostering economic development if policy makers use these constraints wisely and creatively. For a government that would otherwise make a mess of its tariff code, the ability to bind tariffs in the WTO represents a useful opportunity to be snapped up. In an economy with a tendency for large fiscal deficits, the discipline imposed by international financial markets can enhance the prospects for macroeconomic stability. The harmonization of regulatory standards with those in the advanced industrial countries can impart the rule of law and increase transparency in developing countries.

Yet such externally induced disciplines can also backfire if they are inappropriate to the economy in question or are viewed as serving the needs of particular social groups at the expense of others. Two conditions have to be satisfied to ensure that this does not happen:

1. The decision to submit to external discipline—by signing on to international agreements, opening up markets to international competition, or accepting World Bank/IMF conditionality—must be the product of a democratic decision-making process, with broad participation from major social groups.
2. There must be solid evidence that the discipline in question will improve economic performance in the country submitting to it.

International policy regimes that significantly constrain the ability of national policy makers to choose their own paths are likely to prove counter-productive in the absence of these preconditions.

Many international agreements fail one or both of these tests. Some of the agreements negotiated during the Uruguay Round can be cited in this connection. Consider for example the agreement on intellectual property rights (TRIPs), which sets minimum standards of protection in patents, copyrights, and trademarks, and the agreement on trade-related investment measures (TRIMs), which requires the phasing out of performance requirements such as local-content and export-import linkage requirements. These represent cases of “forced” harmonization despite the absence of convincing evidence of benefits to developing nations. TRIPs are a particularly egregious instance, in that what Northern governments really obtained was the transfer of billions of dollars' worth of monopoly profits from poor countries to rich countries under the

guise of protecting the property rights of inventors.⁶⁷ The draft Multilateral Agreement on Investment (MAI), which is in process of negotiation at the OECD, contains many other doubtful restrictions on policy actions.

Some of the proposals to link the strengthening of labor standards in developing countries to trade privileges are problematic from the same perspective. In principle, there is nothing wrong in the international community requiring developing-country governments to protect basic worker rights. At times, this simply amounts to requiring that governments live up to commitments they have already made in the relevant ILO conventions they have ratified, such as those on the freedom of association and the minimum age of work. The freedoms to associate and to organize are basic civil rights, and there is some evidence, as I have shown in previous chapters, that such freedoms are associated with superior economic performance. But often the demands from labor advocates in the North go beyond basic civil rights and political liberties, and prescribe outcomes that may lead to inferior economic performance. The requirement that workers in developing countries be paid a "living wage" or the implementation of specific prohibitions on child labor may well end up doing more harm than good. The argument for international discipline is considerably weaker in such instances.⁶⁸

The proposal to enshrine capital-account convertibility in the IMF's articles of agreement is another idea that lacks empirical justification. If recent evidence teaches us anything, it is that

⁶⁷ The most direct consequence of the TRIPs agreement is an increase in the prices of items like pharmaceuticals for which patent treatment in the developing nations has been traditionally quite weak. The magnitude of the price increase one can expect is indicated by an exercise carried out by Subramanian (1994). Subramanian compares the prices for patented drugs in Malaysia (where patent protection for pharmaceuticals is reasonably tight) with those in India (where it is not). He finds that Malaysian prices are significantly higher than Indian ones, with the premium ranging from 17 percent (for Pentoxifyllin 400 mg tablets) to 767 percent (for Atenolol 50 mg tablets). Insofar as the owners of patents in such drugs are foreign-owned firms (as is the case almost always), developing countries are faced not only with monopoly distortions in the home market, but more importantly with a potentially huge transfer of rents abroad.

there is a compelling case for maintaining controls on short-term borrowing. The three countries hardest hit by the Asian financial crisis—Indonesia, Thailand, and Korea—were the three in the region with the largest short-term obligations (in relation to reserves or exports). It is not that capital controls are necessarily the answer to boom-and-bust cycles in international financial markets; they are not. But capital-account liberalization fits the bill even less. We can imagine cases where the judicious application of capital controls could have prevented a crisis or greatly reduced its magnitude. Thailand and Indonesia would have been far better off restricting borrowing from abroad instead of encouraging it. Korea might just have avoided a run on its reserves if controls on short-term borrowing had kept its short-term exposure to foreign banks, say, at 30 percent, rather than 70 percent of its liabilities.

Admittedly, we know too little about what kinds of controls work best in these circumstances. The evidence on the effectiveness of controls on short-term borrowing is patchy. But incomplete knowledge of this sort is an argument for allowing countries to follow their own preferred paths, selecting their own trade-offs between risk and reward.

A common argument in favor of capital-market integration is that this serves to discipline governments, forcing them to follow sound fiscal and monetary policies. For governments with a penchant for populist macroeconomic policies, such market discipline can serve a useful role, much the same way that tariff bindings under the WTO helps prevent excessive responsiveness to lobbying by industry groups at home. But this argument can be taken too far. In most democratic societies, the discipline needed by governments is provided by electoral accountability and by a constitutional system of checks and balances. Governments that mess up the economy are punished at the polls. It is not at all clear that international markets

⁶⁸ Indeed, the United States has ratified very few of the ILO's conventions, citing its federal structure (and the role of the states in regulatory policy) and other special circumstances.

systematically improve the incentives faced by democratic governments. Certainly, the availability of financial resources on easy terms during periods of market euphoria can encourage fiscal profligacy—rather than penalizing it—and result in quite the opposite effect. Moreover, market discipline empowers financial markets—domestic and foreign—over other constituencies in society, raising serious problems for democratic governance. Hence, in practice the potential value of market discipline has to be traded off against the downside risks.

In sum, policy making at the international level has to create space for national development efforts that are divergent in their philosophy and content. Forcing all countries into a single, neo-liberal developmental model would be unwise—in light of the potential political backlash from national groups—even if there were serious grounds to believe that the model is economically advantageous. It is absurd when the evidence on the model's economic superiority is itself in doubt.

The lesson of history is that ultimately all successful countries develop their own brands of national capitalism. As Alexander Gerschenkron (1965) demonstrated a while back, the patterns of development during the 19th century were quite diverse, and more recent economic history provides little evidence of convergence. The U.S., Sweden, Germany, and Japan, to name just a few instances, are alike in that they are market-based economies that uphold private property and monetary stability. But the economic systems in these countries also differ on many important dimensions, including the organization of the labor market, the style of corporate governance, the extent of social insurance and safety nets, the intrusiveness of the government, and the regulatory framework in product and labor markets. Developing countries can choose among these and no doubt many other paths; they should be left free to do so.

A question of accountability

The internationalization of production and investment raises a fundamental question of accountability: to whom will national economic policy makers be accountable? The implicit answer provided by the globalization model is that they will be accountable to foreign investors, country-fund managers in London and New York, and a relatively small group of domestic exporters. In the globalized economy, these are the groups that determine whether an economy is judged a success or not, and whether it will prosper.

This would not necessarily be a bad thing if the invisible hand of global markets could always be relied on to produce desirable outcomes. The reality is considerably more murky. It takes too much blind faith in markets to believe that the global allocation of resources is enhanced by the twenty-something-year olds in London who move hundreds of millions of dollars around the globe in a matter of an instant, or by the executives of multinational enterprises who make plant-location decisions on the basis of the concessions they can extract from governments. As Eatwell (1997, 246-247) points out in reference to financial markets:

If the financial markets are simply enforcing the logic of real economic efficiency, strengthening the self-adjusting powers of competitive markets, then the "disciplining" of governments would be benign, but if markets are pursuing the rules of a beauty contest and imposing self-fulfilling prejudices on the workings of the real economy, then the outcome may be very damaging... When [markets'] influence is combined with the persistent search for government "credibility," defined in terms of "sound money" and "prudent" deflationary policies, then the [low-growth, high-unemployment equilibrium] is the most likely outcome.

These words, written before the Asian and Russian crises, are remarkably prescient in light of what has come to pass since 1997.⁶⁹

⁶⁹ And not only in East Asia. Developing-country governments all over the world have had to tighten credit for fear of losing their credibility in international financial markets. "Brazil Pays to Shield Currency, and the Poor See the True Cost," was the headline of a New York Times article (authored by Roger Cohen) on February 5, 1998.

What is wrong, therefore, with the first chapter's parable of the fictional finance minister is that the minister is spending the vast majority of his time worrying about how the rest of the world evaluates his management of the economy. Traditional developmental concerns have all but been squeezed out. It is global markets that dictate policy, not domestic priorities.

The fundamental dilemma of accountability in today's world economy is that it is domestic voters that choose national governments—appropriately so—and not global markets. International markets, and particularly financial ones, do not always get things right with respect to economic efficiency. They are even less likely to get things right with regard to societal outcomes suitable to each nation's aspirations. The structure of social institutions in a country, the extent of inequality that is tolerated, the types of public goods to be provided by governments—these are decisions that are, and should be, made at the national level. Choices made regarding social arrangements will vary across nations because of differences in norms, historical traditions, and levels of development. It is national governments that are held responsible for producing outcomes that are consonant with national aspirations. If governments can no longer be responsive to these aspirations, they can no longer be accountable to their electorates.

It may be true, as the conventional wisdom has it, that the information revolution and the globalization of production necessitate novel forms of governance. We need to figure out what these forms of governance are and how we can institute them. But national governments are all that we have at present. It would be unwise to give them up without knowing what will replace them. A suitable international economic system is one that allows different styles of national capitalism to co-exist with each other, not one that imposes a uniform model of economic governance.

APPENDIX

Notes on the data used

Most of the data used in this study come from three sources: the Penn World Tables (Mark 5.6), the World Bank's data files (World Bank 1995, 1997), and the Barro-Lee (1994) data set. Depending on the time period covered and the purpose of the analysis, real per-capita incomes and investment rates are taken either from the Penn World Tables (which are purchasing-power adjusted) or from the World Bank (which are not).

World Bank country codes

Countries in the scatter plots are identified by their World Bank country codes. The country codes are listed below.

CODE	Country	CCODE
1	Algeria	DZA
2	Angola	AGO
3	Benin	BEN
4	Botswana	BWA
5	Burkina Faso	HVO
6	Burundi	BDI
7	Cameroon	CMR
8	Cape Verde	CPV
9	Central African Rep.	CAF
10	Chad	TCD
11	Comoros	COM
12	Congo	COG
13	Egypt	EGY
14	Ethiopia	ETH
15	Gabon	GAB
16	Gambia	GMB
17	Ghana	GHA
18	Guinea	GIN
19	Guinea-Bissau	GNB
20	Cote d'Ivoire	CIV
21	Kenya	KEN
22	Lesotho	LSO
23	Liberia	LBR
24	Madagascar	MDG
25	Malawi	MWI
26	Mali	MLI
27	Mauritania	MRT
28	Mauritius	MUS
29	Morocco	MAR
30	Mozambique	MOZ

31	Niger	NER
32	Nigeria	NGA
33	Rwanda	RWA
34	Senegal	SEN
35	Seychelles	SYC
36	Sierra Leone	SLE
37	Somalia	SOM
38	South Africa	ZAF
39	Sudan	SDN
40	Swaziland	SWZ
41	Tanzania	TZA
42	Togo	TGO
43	Tunisia	TUN
44	Uganda	UGA
45	Zaire	ZAR
46	Zambia	ZMB
47	Zimbabwe	ZWE
48	Bahamas, The	BHS
49	Barbados	BRB
50	Canada	CAN
51	Costa Rica	CRI
52	Dominica	DMA
53	Dominican Rep.	DOM
54	El Salvador	SLV
55	Grenada	GRD
56	Guatemala	GTM
57	Haiti	HTI
58	Honduras	HND
59	Jamaica	JAM
60	Mexico	MEX
61	Nicaragua	NIC
62	Panama	PAN
63	St. Lucia	LCA
64	St. Vincent & Grens.	VCT
65	Trinidad & Tobago	TTO
66	United States	USA
67	Argentina	ARG
68	Bolivia	BOL
69	Brazil	BRA
70	Chile	CHL
71	Columbia	COL
72	Ecuador	ECU
73	Guyana	GUY
74	Paraguay	PRY
75	Peru	PER
76	Suriname	SUR
77	Uruguay	URY

78	Venezuela	VEN
79	Afghanistan	AFG
80	Bahrain	BHR
81	Bangladesh	BGD
82	Myanmar (Burma)	BUR
83	China	CHN
84	Hong Kong	HKG
85	India	IND
86	Indonesia	IDN
87	Iran, I.R. of	IRN
88	Iraq	IRQ
89	Israel	ISR
90	Japan	JPN
91	Jordan	JOR
92	Korea	KOR
93	Kuwait	KWT
94	Malaysia	MYS
95	Nepal	NPL
96	Oman	OMN
97	Pakistan	PAK
98	Philippines	PHL
99	Saudi Arabia	SAU
100	Singapore	SGP
101	Sri Lanka	LKA
102	Syria	SYR
103	Taiwan	OAN
104	Thailand	THA
105	United Arab Emirates	ARE
106	Yemen, N.Arab	YEM
107	Austria	AUT
108	Belgium	BEL
109	Cyprus	CYP
110	Denmark	DNK
111	Finland	FIN
112	France	FRA
113	Germany, West	DEU
114	Greece	GRC
115	Hungary	HUN
116	Iceland	ISL
117	Ireland	IRL
118	Italy	ITA
119	Luxembourg	LUX
120	Malta	MLT
121	Netherlands	NLD
122	Norway	NOR
123	Poland	POL
124	Portugal	PRT

125	Spain	ESP
126	Sweden	SWE
127	Switzerland	CHE
128	Turkey	TUR
129	United Kingdom	GBR
130	Yugoslavia	YUG
131	Australia	AUS
132	Fiji	FJI
133	New Zealand	NZL
134	Papua New Guinea	PNG
135	Solomon Islands	SLB
136	Tonga	TON
137	Vanuatu	VUT
138	Western Samoa	WSM

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