

POLICY COHERENCE, DEVELOPMENT STRATEGIES AND INTEGRATION INTO THE WORLD ECONOMY



INTRODUCTION

Beginning in the mid-1980s, many developing countries made close integration into the international trading system a pillar of their economic reform agenda. They sought to achieve this not only through active participation in multilateral trade negotiations, but also through rapid unilateral trade liberalization. In many countries, trade liberalization was accompanied by an opening up of their financial sector and capital account. Rapid liberalization and increased exposure to international market forces and competition were expected to boost efficiency and competitiveness, which in turn would underpin a more rapid rate of economic growth and a narrowing of the income gap with developed countries. However, by the early 1990s there were many instances where the outcome of this policy strategy did not live up to expectations.

The prevailing analysis suggests that the often disappointing developmental effects of closer integration into the world economy are due to persistent market access barriers to a number of key developing-country exports. They are also due to the absence in many developing countries, and particularly the poorest among them, of appropriate governance and institutional frameworks and to a lack of productive capacities to respond quickly to export opportunities, even when they benefit from preferential market access conditions.

The disappointing developmental effects of closer integration led to increasing pressure on developed countries to abolish market access barriers to products of export interest to developing

countries. At the same time, developing-country policy-makers began to be encouraged to adopt measures designed to strengthen the supply capacity of their economies with a view to building competitive industries and benefiting from improved access to world markets. Increasing attention was given to improving macroeconomic and exchange-rate management; appropriate sequencing of liberalization of the trade, financial and capital-account regimes, underpinned by prudential regulation and financial sector reform; reinforcing domestic institutional capacity; and attracting foreign direct investment (FDI). This policy package was expected to enable developing countries to overcome the constraints they face with regard to fixed investment and technological upgrading, and to raise productivity.

Underlying the advice to adopt this policy package is the assumption that all economies, regardless of their size, institutional histories or level of development, respond in much the same way to a uniform set of price incentives. Further, there is an implicit suggestion that achieving such a uniform set of price incentives and keeping it free from distortions is best guaranteed by allowing international markets to set prices. It is argued that this is in large part because the higher degree of competition in those markets comes closest to an ideal level of “contestability”, and because the absence of government interference helps minimize the distortive impact of “rent seeking” or “directly unproductive profit-seeking” activities. Proposing this development strategy – which may be called the “openness model” – implies the view

that coherent policy-making is based on a shared understanding of a uniform set of instruments of trade, macroeconomic, financial and development policies. It has also meant, in practice, that developing countries trade discretionary policy measures for the promise of improved access to international markets for their goods, and to finance and technology. On this account, while making this bargain work depends principally on actions taken “at home”, it also implies strengthened policy surveillance from, and more effective collaboration among, international economic institutions (Mussa, 1997; Winters, 2001).

To date, adopting this strategy has still not enabled most developing countries to establish the virtuous interaction between international finance, domestic capital formation and export growth, which underpinned the catching-up process of Western Europe after the Second World War and of the East Asian newly industrializing economies (NIEs) during the 1980s and early 1990s. Critics have attributed this to the uniform application of neo-liberal policies, which does not take account of the diversity of economic conditions and challenges found in low and middle-income economies. Others have pointed to growing social tensions accompanying rapid opening up, which have had an adverse impact on efficiency and growth. Moreover, in an increasingly interdependent world, the very idea of a spontaneous economic order in which developing countries, by putting their own house in order through opening up to international market forces can guarantee the kind of stability needed for sustained growth in incomes and employment, appears to many as decidedly “utopian” (Rodrik, 2002: 24).¹

Part Two of this Report suggests that efforts at designing a feasible development agenda require a more complex analytical and policy framework than that offered by the “openness model”. This framework must explore how the virtuous interactions between export activities, domestic capital formation and structural change are established. It should further consider potentially destabilizing interactions between trade and other elements of the integration process, particularly those associated with international finance. And it should explicitly include the legitimate role that economic institutions at the national level play instead of relying on a vision of the world in which indi-

vidual economic agents will react to prices that reflect relative scarcities of goods and production factors at the global level. In this way, it would provide a framework for identifying the combination of domestic policy-making and collective actions at the international level needed to manage the potential adjustment costs and tendencies towards economic divergence that accompany deeper integration, particularly where it brings together countries at very different levels of development.

In what follows it is suggested that a policy package based on the concept of “coherence” will enable better management of contemporary globalization processes in the interest of economic development. It is shown that the “openness” approach, in order to work, requires coherence between national development strategies and global processes and disciplines, as well as policy coherence between and within the various aspects/sectors of the global economy that impact on development prospects of developing countries. All these are lacking to some extent in today’s global economy.

A coherent treatment of the interdependence between trade, development and financial issues was an important element in the debate leading to the set-up of the post-war international economic system. This debate arose from the desire to avoid deflationary adjustments and beggar-thy-neighbour policies of the kind that had severely disrupted economies in the inter-war period.

The present institutional set-up has its roots in the arrangements that resulted from the reorganization of international economic relations after the Second World War. The set-up of the post-war international trade regime was predicated on the belief that, in conditions of strictly limited private international capital flows, an international monetary system on an intergovernmental basis with convertible currencies at fixed, but adjustable, exchange rates would provide a stable environment conducive to trade and investment. Under the aegis of the General Agreement on Tariffs and Trade (GATT), this regime considered the tariff as the only legitimate trade policy measure. Other trade measures (i.e. those affecting quantities or the fixing of import prices) were prohibited, except in certain clearly defined circumstances. The convertibility of currencies at fixed, but adjustable, exchange rates supported the GATT approach,

as participants in international trade negotiations could predict the full extent to which the competitive position of domestic industries would be affected by tariff cuts without having to be unduly concerned about other exogenous factors or resorting to competitive devaluations to balance unanticipated adverse consequences of trade liberalization.

The rules-based system of trade negotiations in the form of the GATT was all that survived from the initially proposed charter of the International Trade Organization (ITO), whose mandate would also have included to coordinate national economic policies to ensure adequate levels of global demand and employment in support of the development of low-income countries. As such, the specific problems of developing countries participating in the post-war international trading system were largely absent from the mandates of the inter-governmental institutions created immediately after the Second World War. Multilateral efforts to remedy this neglect culminated in the First UNCTAD Conference in 1964. Central to that discussion was the idea that developing countries can base economic development on their own efforts only if they have sufficient policy space to accelerate capital formation, diversify their economic structure and give development a greater “social depth”. This discussion also emphasized the interdependence between trade, macroeconomic and financial policy issues.

The need for a coherent treatment of these issues has gained in importance with the abandoning of the system of fixed, but adjustable, exchange rates and the adoption of widespread floating, combined with a return of private international capital flows to levels similar to those that had caused instability in the inter-war period. Indeed, there are growing concerns about the adverse impact on trade of exchange rate instability created by financial factors, in particular, in the context of the financial crises that have hit a number of emerging-market economies over the past decade. The risk of sharp currency depreciations, which, as demonstrated by the Asian crisis, can arise even in countries with sound macroeconomic and external positions, increases the perceived cost and uncertainty of trade, and discourages governments from lifting trade restrictions. In practice, large currency depreciations by some crisis-hit coun-

tries have provoked claims of “unfair trade” from import-sensitive sectors in some of their main trading partners and pressure for a trade policy response. This runs counter the generally recognized principle that trade restrictions should not be used to offset a rise in the international cost competitiveness of competitors resulting from fluctuations in exchange rates.

There is no disputing that trade must continue to occupy a central place in an effective global partnership for development, or that all countries have a mutual interest in the effective functioning of the multilateral trading system. However, trade and financial linkages with the world economy can only complement, but not substitute, for domestic forces of growth. Moreover, these linkages need to be coherent with national development strategies designed to generate virtuous interaction between domestic capital formation and export activities. Establishing such virtuous interactions can be achieved by a national development strategy that is successful in augmenting the existing stock of physical and human capital, enabling the use of more efficient technologies, and shifting resources away from traditional, low-productivity activities towards activities that offer a high potential for productivity growth. Under some circumstances, and particularly when a period of real currency appreciation has hampered export performance, real currency depreciations can improve international cost competitiveness and boost exports. On the other hand, sizeable exchange rate volatility can offset annual gains in domestic productivity and drastically alter international cost competitiveness virtually overnight. Moreover, sharp and abrupt depreciations can make it difficult for exporters to take advantage of the rise in international cost competitiveness resulting from such depreciations. The fact that sizeable exchange rate volatility and major exchange rate depreciations have typically been associated with shifts in the direction of short-term international capital flows shows that insufficient coherence in the international monetary and financial system can jeopardize the successful implementation of national development strategies designed to foster domestic supply capacities.

The following discussion documents the lack of policy coherence in today’s global economy and proposes ways to approach the issues of coher-

ence so as to maximize the developmental effects of integration into the world economy.

Chapter III first discusses the issues arising from greater trade and financial integration looked at from the perspective of interdependence between trade, macroeconomic and financial issues as well as between openness and integration in the world economy, and domestic policy space. Chapter IV shifts the focus to the impact of monetary and financial factors on the supply side of developing-country exports. It examines the particular effects caused by sharp and abrupt currency

depreciations on the trade performance of developing countries and goes on to analyse monetary policy options with regard to fixed or flexible exchange rates in the context of high volatility of short-term capital flows. The concluding section summarizes the main arguments and discusses policy challenges to enhance coherence between the international trading, monetary and financial systems with a view to establishing a virtuous interaction between international finance, domestic capital formation and export growth and maximizing the developmental effects of integration into the world economy. ■

Note

1 For the evidence on growth performance, see *TDRs 1997 and 2003* and UNCTAD, 2002; on the problems of applying uniform policy advice, for Africa see *TDR 1998* and UNCTAD, 2001, for Latin

America see ECLAC, 2002, and for countries in Central and Eastern Europe see ECE, 1990. On the damaging social impact of these policies see UNDP, 1999; UN-HABITAT, 2003; and ILO, 2004.

OPENNESS, INTEGRATION AND NATIONAL POLICY SPACE

A. Introduction

The move to unrestricted cross-border flows of goods, services and capital has always been one of the principles of globalization. Since the late 1970s, “the propensity to truck, barter and exchange one thing for another” (Adam Smith), unhindered by political boundaries, has been regarded as the cornerstone of a global system that would produce efficiency gains from allowing resources to be directed to their most efficient use, and specialization gains from accessing a greater variety of intermediate and capital goods. If improved institutional quality and technology spillover are added, trade and capital openness should automatically allow for catch-up growth in poorer countries and bring about income convergence at the global level (see, for example, IMF, 2002; WTO, 1998; World Bank, 2002; Winters, 2004). But the empirical evidence supporting this approach has been elusive. In fact, most of the evidence suggests that the impact of trade openness has been highly uneven, and contingent on a variety of institutional factors, and that there is room for discretionary policy measures at the micro and macro level.¹

A more balanced perspective, also taking its cue from Adam Smith, links a process of success-

ful integration back to productivity gains from specialization, gains that are amplified through innovation, the use of better equipment, scale economies at the firm level and by “externalities” such as learning and improvements in human capital. This ties economic success to a heightened degree of economic interdependence through the mutually reinforcing interactions between expanding markets and an increasingly complex division of labour (Young, 1928). Extending and deepening such interactions depends on new investments under conditions of objective uncertainty. To improve and expand existing capacity as well as to introduce new products and processes, a “profit-investment nexus” is needed that requires supporting financial arrangements, including accommodative monetary policy and relatively stable legal institutions.² Under the right conditions, high profits will increase the incentive of firms to invest, as well as their capacity to finance new investment; this in turn boosts profits by enhancing the rates of capital utilization and the pace of productivity growth. For most countries, this nexus is closely linked to industrialization, where the presence of scale economies, externalities and an array of indivisibilities and complementarities in production and consumption are strongest, and

from where productivity growth feeds into a wider process of structural change as labour shifts out of lower value-added sectors into more capital- and technology-intensive activities and complementary service activities.

At the same time, as the increasingly interdependent nature of industrial activity heightens the gains from specialization, it also exposes more and more individuals, firms and communities to an increased threat from discontinuities and disruptions. Ruptures occur from myriad shocks and coordination failures across imperfectly functioning (or missing) factor and product markets.³ As a result, a successful and sustained “take-off” requires the evolution of a range of complementary norms, policies and regulations that help discipline and restrain the more destructive and nurture the more creative forces of the emergent industrial economy. A general lesson from history is that “policy space” expands considerably with the transition from a world dominated by agriculture, slow-moving technology and small-scale business to one dominated by manufactured goods, rapidly evolving technology and big firms.⁴

Hence, the potential benefits from participating in a more detailed international division of labour must be weighed against the coordination and adjustment costs arising from the heightened interdependence accompanying further specialization in, and fragmentation of, economic activities. Indeed, the fact that interdependence is now taking place across borders adds new constraints, rivalries and risks to sustained economic progress. However, there remains a basic challenge for economic policymakers: to decide whether and to what extent market forces can be left alone to ensure that progress is consistent with increased participation in the international economy, and when and what kinds of policies and institutional arrangements might be needed to better manage the process.

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The evolving international division of labour is further complicated as large national firms in more advanced economies acquire the capabilities and the possibilities to organize and control their production activities across borders (Hymer, 1976; Dunning, 1981). While the timing and the direction will vary among countries and sectors, the decisive elements in the internationalization of production are firm size, control over rent-creating strategic assets and market penetration. Since large firms tend to have more capital at their disposal and more control over market forces, they will do the most overseas investing.

Finally, the growth of trade and the rise of international firms accelerate the mobility of capital and extend the reach of financial institutions. At the domestic level, these institutions essentially help to channel resources for investment purposes by reconciling the differences between borrowers and lenders in the timing of payments, and transforming short-term liquid liabilities into long-term illiquid assets. The efficiency of the system will be reflected in its ability to minimize the liquidity premium and the risk of erroneous investment decisions (*TDR 1991*). As international trade and production expand, specialized financial institutions are joined by international banks seeking to widen the scope and reach of their services to sovereign and local governments, to local financial institutions and non-bank firms. They concentrate their borrowing in markets with the lowest interest rates and their lending in markets with the highest, with funds moving whenever the differential is greater than the transaction costs.

The resulting cross-border flows of capital can help deepen the international division of labour by offsetting structural weaknesses resulting from persistent trade deficits, and allowing a faster pace of investment than might otherwise be possible from domestic resources. In poorer economies, such flows can thereby reinforce a

catch-up growth dynamic. However, these flows are highly information sensitive, and vulnerable to information asymmetries, contract-enforcement problems and macroeconomic risks. They also tend to be more footloose than other cross-border economic flows, in part, because of its openness to innovative techniques in search of the preferred combination of liquidity and returns. Under these conditions, both the direction and the terms of borrowing can become major sources of discontinuity across the international division of labour. Moreover, an expanding international economy presents new and riskier profit opportunities, allowing liquid capital a greater margin to seek out short-term arbitrage positions and speculative gains. As a result, such flows can be extremely volatile and subject to pro-cyclical bandwagon effects; they can cause gyrations in security prices, exchange rates and trade balances, and make financial crisis a “hardy perennial” of the international market economy (Kindleberger, 1975).

Thus, integration is not just, or even most importantly, about the efficient use of given resources, but rather about extending and reinforcing

the cumulative gains of local dynamic growth forces through exports and capital flows. However, and as at the domestic level, those forces introduce discontinuities, shocks and potential conflicts of interest, which can generate sizeable adjustment costs for national economies participating in the international division of labour; they may even trigger divergence away from leading economies. From this perspective, the real challenge is not so much about the extent or the sequencing of liberalization, but about finding the particular combination of international market forces, policy space and collective action needed by countries with different institutional and industrial capacities, to ensure that the integration process is welfare-enhancing for all participants in the international division of labour.

Historically, finding that balance has proved difficult, making for an ebbing and flowing of the integration process. The following sections examine a number of episodes where incoherence has arisen as a result of a lopsided emphasis by policy-makers on openness, at the expense of policy space and coordinated actions.

B. Unbalanced integration in the 1920s

The inter-war period is often flagged as a warning of what can happen when the virtues of openness are foregone in favour of narrower national and sectoral interests. From this perspective, a series of ill-judged interventionist measures, particularly a retreat into tariff protection, but also misguided monetary interventionism by central banks, excessive social spending and restrictions on labour mobility, have been blamed for plunging the world economy into a destructive pattern of autarkic development (Crucini and Kahn, 1996; World Bank, 2002; Wolf, 2004).

But while there can be no doubting the scale or extent of economic damage from the crisis that engulfed the global economy in the early 1930s, or the political turmoil that followed in its wake, such accounts are often guilty of painting the inter-war economic experience in unduly simple terms. In particular, they downplay the relatively strong recovery in international economic relations in the 1920s, marked by an overall rise in the share of trade in world GDP, as well as a revival of capital flows, notably a boom in sovereign borrowing and some growth in FDI (tables 3.1 and 3.2). They

Table 3.1

MERCHANDISE EXPORTS AS A SHARE OF GDP, 1913 AND 1929		
<i>(Per cent)</i>		
	1913	1929
Western Europe	16.3	13.3
France	7.8	8.6
Germany	16.1	12.8
Netherlands	17.3	17.2
United Kingdom	17.5	13.3
United States	3.7	3.6
Canada	12.2	15.8
Latin America	9.5	9.7
Asia	2.6	2.8
Japan	2.4	3.5
World	7.9	9.0

Source: O'Rourke (2002: table 2).

Table 3.2

FOREIGN DIRECT INVESTMENT, 1913 AND 1938		
<i>(Outward stock of FDI/GDP, per cent)</i>		
	1913	1938
Canada	6	14
France	23	21
Germany	11	1
Japan	11	21
Netherlands	82	91
United Kingdom	49	38
United States	7	8

Source: Twomey (2000).

also ignore the general policy direction taken by the international community to reorganize post-war economic relations around the goal of openness, and, consequently, fail to consider how that policy agenda contributed to mismanaging the return to stability.

Although the end of the First World War left Europe in a state of political and moral uncertainty,

economic policy-makers held up the economic order in the period before 1914 – the *belle époque* – as a state of “normalcy” which needed to be restored as quickly as possible (Bayen, 1954). Indeed, this was seen as the most fundamental step to achieving wider peace and stability, and was premised on restoring the pre-war international monetary system, which was expected to guarantee price stability under a system of fixed exchange rates tied to gold.

From this starting point, a policy consensus was forged, which aimed at restoring flexibility at the microeconomic level through the elimination of trade barriers and other market distortions erected during the war, and the establishment of harmonious trade conditions around the principle of non-discrimination (as proposed in Article 3 of the Versailles Peace Accord). It also aimed at recovering stability at the macroeconomic level by first reducing the high level of public debts acquired during the war, through fiscal surpluses achieved by an initial round of expenditure cuts and increased taxes, followed by tight restrictions on any subsequent efforts to expand government spending. At the same time, monetary policy would be put back in the hands of technocrats working through independent central banks, and in accordance with the requirements for freely flowing international capital.

Primary responsibility for implementing this agenda rested with domestic policy-makers. However, it was acknowledged that, as a consequence of the war, privileging international market forces might cause political resistance, and that, consequently, pressure could usefully be brought to bear on policy-makers to push them in the desired direction. The initiative was taken in a series of international economic conferences beginning in Brussels in 1920, and followed up over the next 13 years in Genoa, Portorose, Geneva, Lausanne and London (Pauly, 1997). Efforts were also made to bring about closer central bank cooperation (Eichengreen, 1996). More radically still, in cases where economic imbalances and political uncertainties were particularly pronounced, stabilization would be achieved through adjustment programmes managed by the League of Nations.

By assuming an underlying “natural” state of fully employed resources, adjustments accom-

panying economic openness were expected to be small in scale and short in duration, allowing international markets to establish the right price incentives, and bringing about a rapid return to growth and stability. With eyes firmly fixed on the past, the sequence of reforms aimed to get long-term capital flowing again before opening up trade, although it was generally accepted that success ultimately hinged on re-creating the mutually supportive pattern of trade and capital flows that existed before 1914.

With economic policy-makers expecting the gold standard to deliver long-term growth and stability, the room for policy action to bring about an orderly adjustment in and across countries was squeezed between measures to regain and maintain the confidence of financial markets and to allow competitive pressures to re-establish external balance. Little attention was given to whether pre-war monetary arrangements were appropriate for the emerging post-war pattern of economic integration, or whether the steps taken by individual countries to regain stability might actually add to the incoherence in international economic relations.

The belief that marginal adjustments through the marketplace would bring global stability clouded the judgement of policy-makers as to the scale of investment, both private and public, needed to rebuild and modernize a European economic space transformed by the dislocations of war, the break-up of old empires and the rising voice of organized labour. In particular, the economic consequences of accumulated wartime debts and German reparations were greatly underestimated. In the absence of their cancellation, highly indebted countries were faced with the onerous task of generating both a fiscal and a trade surplus to meet their international financial obligations, even as they struggled to repair the damage to productive capacity and investment prospects. Moreover, the problem was not just one of managing sovereign debt; in many countries, bank capital, depleted by post-war inflation, had to be shored up by foreign borrowing, and corporate debts accumulated during the war increased further under the post-war restructuring efforts through both foreign bond issues and bank borrowing supported by foreign loans (Kregel, 1996a); in agriculture too, which remained a major source of foreign-exchange earnings and employment for many countries – in-

Table 3.3

**AVERAGE TARIFF RATES ON
MANUFACTURED PRODUCTS FOR
SELECTED COUNTRIES, 1913–1931**

(Weighted average in percentage of value)

	1913	1925	1931
Belgium	9	15	14
France	20	21	30
Germany	13	20	21
Italy	18	22	46
Japan	30
Sweden	20	16	21
Switzerland	9	14	19
United Kingdom	0	5	..
United States	44	37	48

Source: Bairoch (1993).

cluding the United States and France – rising levels of indebtedness anticipated a pattern of instability previously confined to primary exporters on the periphery.⁵

As the constraints on investment were underestimated, so the prospects for strong and rapid export recoveries were overestimated, particularly for the industrial heartland of Europe, where a rapid return to pre-war export performance was essential to meet financial obligations without further damaging the domestic economy. A disappointing trade performance cannot, however, be explained simply as being the result of an unforeseen protectionist wave. In fact, trade policies were broadly re-established along pre-war lines: quantitative controls were quickly abolished, tariff levels returned to earlier levels – which were quite high, particularly for manufactures (table 3.3) – and the commitment to non-discrimination (in the form of most-favoured-nation (MFN) treatment) was generally confirmed.⁶ In Germany, a severely weakened manufacturing sector faced added obstacles, as newly independent economies in Eastern Europe looked to support their own infant industries through tariff protection, and the persistence of high tariffs in surplus economies, notably the United States, dampened prospects for an export-led recovery (Chang, 2002). In the case of Britain, the loss of markets in key sectors such

as coal, textiles and shipbuilding also reflected the rise of new competitors in its traditional colonial markets. But the real challenge facing these older industrial economies was to respond to the new and strengthened manufacturing capacity that had emerged elsewhere during the war through renewed investment in more dynamic industries.

Under these conditions, the decision of Europe's leading industrial centres to return to the gold standard at the pre-war parity level damaged prospects of a strong export recovery,⁷ and the resort to tight macroeconomic policies to defend that decision further compromised efforts to re-establish a dynamic profit-investment nexus. The resulting sharp slowdown of growth in the European industrial heartland was itself an important contributory source of weak trade performance and a major reason why trade levels in 1929 were below what might otherwise have been expected. By contrast, countries that re-entered the gold standard with devalued currencies saw strong growth in trade, persistent surpluses, an earlier recovery in investment and comparatively lower levels of unemployment. This was notably true of France – which was still an industrial laggard – and Belgium, as well as other smaller European countries.

Given these conditions, and with no hope of a coordinated debt write-off, exposure to a series of unfamiliar dangers from rising debt charges, falling prices and the shifting sentiments of financial markets, made policy-makers in the 1920s a good deal more “balance-of-payments conscious” (ECLA, 1965: 15). Effective management of the resulting policy trade-offs was complicated by the shifting interests of leading creditor and debtor countries. Under the gold standard, long-term capital flows and an increasingly complex multilateral trading system were mutually supportive, largely because the United Kingdom's foreign lending was a substitute for its domestic investment. In addition, its deficit on

the trade account was offset by a surplus on the current account due to earnings on foreign investment, which allowed it to maintain open markets, even in the face of rising protectionism abroad.

Moreover, a general sense of credibility centred on confidence in the stability of the pound sterling, allowing short-term capital flows to play a complementary stabilizing role, at least in the core countries (Eichengreen, 1996).⁸

With no clear leadership of the financial system and persistent worries about a gold shortage, economic uncertainty was added to the political doubts of the post-war world, thus delaying further any recovery in long-term capital flows. In the absence of policy coordination between surplus and deficit countries, the system relied increasingly on short-term capital, through portfolio flows and bank lending, to maintain a degree of balance and to bolster reserves. Such flows occurred on an unprecedented scale, led by United States investors who were attracted by high returns thanks to tight European monetary policies and minimal exchange rate risks. These flows introduced a much more speculative dimension to the recovery, which had started in the second half of the 1920s following the Dawes Plan and the restoration of the gold standard in the United Kingdom. Indeed, with limits to an export-led recovery, and domestic expansion restricted by high domestic interest rates and persistently high levels of unemployment, capital inflows were used increasingly to meet debt repayments in a Ponzi-type of financing⁹ (Bayen, 1954).

Thus, the international economy which took shape in the 1920s was very different from the one that had collapsed in 1914. The combination of exchange rate risk, volatile capital movements and a high and rising debt stock meant that deflationary pressures, financial fragility and the threat of contagion were closely intertwined. Under these circumstances, a country's balance-of-payments position and its reserve situation became

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much more prominent indicators of economic vulnerability and distress, and triggers for short-term capital movements.¹⁰ The boom in the second half of the 1920s failed to stimulate productive investment or create sufficient jobs in the leading industrial economies; it provided only a temporary cover for these structural problems, even as trade expanded and the openness agenda was given a renewed sense of vigour.

In 1927, with the gold standard back in place, the attention of policy-makers shifted to trade openness. Although the International Economic Conference in Geneva produced few concrete outcomes, it added momentum to extending the principles of the “Manchester School” and the advantages of free competition to the trading system through a “beefed-up” League of Nations secretariat (Pauly, 1997: 55–61). But within six months after that Conference, capital flows from the United States to Europe dropped off sharply following an equity surge on Wall Street, and continued to fall when United States interest rates were hiked in an effort to curb “irrational exuberance”. The result was a further tightening of monetary policy in Europe. At the same time, agricultural prices, which had been falling for some years, showed a marked downward fall in 1929, as exporters intensified their efforts to generate foreign exchange in the face of dwindling capital inflows and mount-

ing payment difficulties on outstanding loans. The remaining policy option, of deflationary measures to counter widening imbalances in external payments by cutting imports, simply shifted the problem elsewhere. This made a bust in heavily indebted European economies inevitable, and once it happened, it ensured there was little to stop it spilling over into “twin” banking and currency crises.

With sensible collective responses ruled out by an absence of leadership at the international level, and little thought given to the peculiar circumstances under which the international financial and trading system had operated before the war, the idea of a return to “normalcy” in international economic relations was, from its inception, built on unstable foundations. Still, economists’ belief, propagated through international conferences, that the only option was to build the confidence of financial markets as a prelude to the recovery of international capital flows and the reduction of trade barriers, led to an unhealthy restriction on policy space at home, even as it promoted a blind faith in international market forces as a means to regaining stability. Given the size and nature of adjustments to be made, such thinking contributed to a destabilizing mix of deflationary pressures and volatile capital flows, which eventually culminated in the “beggar-thy-neighbour” policies of the 1930s.

C. Recasting multilateralism: development challenges and the origins of UNCTAD

The post-World War II multilateral agenda arose from the desire to avoid deflationary adjustments and beggar-thy-neighbour policies of the kind that had severely disrupted the inter-war economy. It was premised on an expanded policy space which would allow policy-makers to combine a reasonable degree of price stability with

full employment and growth. But, perhaps just as importantly, the inter-war period had confirmed that industrial countries were too specialized and interdependent to achieve economic stability and lasting improvements in economic welfare without the establishment of some kind of new international economic order. Thus, and quite unlike

the years following the First World War, policy-makers were not only willing to consider a range of more active international policy instruments and measures – an international currency, provision of international liquidity, multilaterally negotiated trade rules, a managed exchange rate system, controlling of destabilizing capital flows – but to discuss what kinds of international arrangements would be needed to manage these most effectively.

Discussions about these were already under way in the late 1930s, and as plans on the reorganization of post-war international economic relations advanced, the institutional arrangements proposed included:

- An international monetary fund to ensure an orderly system of multilateral payments by means of stable but adjustable exchange rates, in conditions of strictly limited private international capital flows;
- An international bank for reconstruction and development to provide long-term capital for post-war reconstruction by encouraging and supplementing private capital flows;
- An international trade organization to provide a rules-based framework to facilitate multilaterally negotiated reductions in trade barriers, as well as to coordinate national economic policies to ensure adequate levels of global demand and employment in support of the development of low-income member countries;
- An international commodity stabilization fund for bringing about stability of prices of raw materials and primary commodities through the creation of international buffer stocks; and
- An international employment agreement which would commit countries to full employment along with the requisite international measures and arrangements to oversee and implement such an obligation.

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Common to the proposed mandates of all these institutions was the recognized need for coordinated policy efforts to create an open multilateral trading system that would benefit, rather than threaten, domestic income and employment, and tether unruly capital flows to ensure financial and exchange rate stability (*TDR 1984*). This institutional project was never completed; the final outcome reflected prolonged (and noticeably asymmetric) negotiations between the passing global hegemonic power (the United Kingdom) and the ascendant

one (the United States). In the end, only the International Monetary Fund (IMF) was established, on the lines of a stabilization fund proposed by Harry White and the United States delegation, along with the (under funded) International Bank for Reconstruction and Development (IBRD). An international agreement on employment was strongly opposed by the United States (as a purely domestic issue), but was eventually tied to the trade agenda through a proposed charter for an International Trade Organization (ITO). However, this subsequently failed to gain ratification in key countries, notably the United States. A limited portion of the ITO mandate was reworked into the General Agreement on Tariffs and Trade (GATT), but the idea of a Stabilization Fund for commodities was dropped altogether.¹¹

The formative years of these multilateral arrangements produced mixed outcomes. The GATT negotiations were primarily concerned with the exchange of tariff concessions extended on a multilateral basis under the unconditional MFN clause. A series of tariff-reducing rounds between 1947 and 1956 saw average tariffs fall, albeit front-loaded on the opening Geneva Round (when the United States reduced its tariffs by an average of 20 per cent on all dutiable imports); while their immediate economic impact was probably not significant, they did help to establish the principle of a tariff-based multilateral system and a commitment to a measured liberalization process (*TDR 1984*: 63). By contrast, the scale of the reconstruction challenge, and the transition back to a situation where the IMF could begin to fulfil its

Table 3.4

**ECONOMIC PERFORMANCE BEFORE THE FIRST WORLD WAR AND
AFTER THE SECOND WORLD WAR IN SELECTED COUNTRIES**

(Average annual growth rates)

	1870–1913			1950–1973		
	Investment	Export	GDP	Investment	Export	GDP
Canada	..	3.1	3.8	5.5	7.0	5.2
France	..	2.8	1.7	4.5	8.2	5.1
Germany	3.1	4.1	2.8	6.1	12.4	6.0
Italy	2.5	2.2	1.5	5.1	11.7	5.5
Japan	2.7	8.5	2.5	9.2	15.4	9.7
United Kingdom	1.4	2.8	1.9	3.9	3.9	3.0
United States	4.7	4.9	4.1	4.0	6.3	3.7

Source: Maddison (1982: tables 3.2, 3.7 and 5.4).

responsibility to promote exchange rate stability and manage orderly balance-of-payments adjustments, were greatly underestimated, and transitional arrangements were required to manage the process. However, the predicted return of economic stagnation did not materialize, so that the problems of short-term adjustment were easier to solve, and United States authorities and financial institutions were able to assume a pivotal role in managing the system.¹²

While the reliance of the system on the economic fortunes of the dominant economic power was inevitable in the short run, it left a series of weaknesses and shortcomings; some of these would only become fully apparent once post-war economic relations stabilized in the late 1950s (Panic, 1995; Eichengreen, 2004). The arrangements were, nevertheless, successful in bringing together a club of similar economies that had been converging on each other for some time (Baumol, 1986), and their economic closeness made the task of learning to work together easier. The combination of favourable economic conditions, a consensus on policy objectives with sufficient policy space, and supportive multilateral institutions provided a climate of predictability and stability

in an increasingly interdependent international economy. It also allowed the building of a strong nexus between investment and exports. Recovery led to rapid and sustained growth, which ensured that the adjustment costs associated with closer trade integration were contained and the benefits broadly shared (*TDR 1997*). The result was a quarter of a century of unprecedented economic growth and stability (table 3.4).

For those outside this club, the kind of export-based profit-investment nexus underpinning growth in the more advanced economies appeared to be weak or absent. Moreover, while the obstacles to growth facing developing countries had surfaced in the context of wartime military and political alliances, these remained marginal in the Bretton Woods negotiations.¹³ A truly development *problématique* did not begin to take shape in the World Bank until the mid-1950s, and was not really completed until the early 1960s when the International Development Association (IDA) was established. Moreover, the World Bank's original mandate as a guarantor of medium- and long-term loans meant it lacked an independent capacity to create development finance, and its dependence on funds raised from the main capital markets ham-

pered its ability to meet the emerging structural needs of developing countries (Akyüz, 2004).¹⁴ Perhaps more damaging still, in this respect, was the failure to adopt the Havana Charter, which contained a number of elements of more immediate interest to poorer countries.

Consequently, the first real strides in development policy analysis occurred outside the Bretton Woods institutions. They drew heavily on the newly emerging discipline of growth theory, but were conceived more broadly in the context of a transition from industrial “backwardness”. The resulting development strategy was built around two main challenges facing low-income economies: the shortage of capital was seen as the biggest constraint on the structural transformation needed in poorer countries to sustain faster growth; and it was believed that breaking that constraint could not rely on market forces alone. Given low private domestic savings rates, along with low income, a non-inflationary way to close the gap between domestic savings and investment was found in external flows of capital from rich to poor countries in the form of private investment, loans and development assistance. But the scale of the challenge was underestimated. While early estimates by the United Nations put the resource requirements of developing countries from foreign sources at \$15 billion a year, World Bank loans averaged between \$200 million and \$400 million annually during the 1950s, with bilateral flows averaging \$2 billion annually from 1950 to 1955, rising to over \$4 billion by the end of the decade (*TDR 1984: 90*).¹⁵ Private capital flows were even more limited, and almost exclusively took the form of direct investments in the commodity sector. Moreover, as economic thinking on development grew in sophistication, and was deepened and refined by academics and policy-makers from the developing countries themselves, efforts to

The combination of favourable economic conditions, a consensus on policy objectives and supportive multilateral institutions provided a climate of predictability and stability.

The point in the international trading system where asymmetries between centre and periphery appeared in sharpest focus was in the terms of trade for primary exports.

measure the size of the resource gap revealed developing countries to be net exporters of capital, once the repayment of loans, terms-of-trade losses and capital flight were included in the calculation.¹⁶

With international private capital flows constrained and development assistance still limited (and often tied), increasing attention was focused on the role of international trade as a more dependable means of removing the resource constraints on economic growth in poorer countries. This marked something

of a break with the trade pessimism which had been a powerful current both before and after the war (Rayment, 1983), particularly in developing countries, where the collapse of the trading system in the 1930s had forced a greater reliance on the domestic market. However, neither the multilateral trading arrangements, where the GATT had become a largely technical instrument for managing trade between rich countries, nor the most dynamic regional trading arrangements, notably the evolving European Common Market (*TDR 2003*), were appropriate venues for improving developing-country participation. Between 1950 and 1960, the share of developing countries in world trade fell from 31 per cent to 21 per cent, and even in primary commodities, their share fell from

41 per cent to 29 per cent. As a result, the kind of export-based profit-investment nexus that was underpinning the successful pattern of interdependence among advanced economies, appeared to be weak or missing altogether in the developing world.

An examination of the comparative trade performance of rich and poor countries published by the GATT in 1958

and prepared by the noted economist Gottfried Haberler, confirmed that tariff and other barriers, particularly against food-exporting developing countries, was one source of the problem.¹⁷ Still, the Haberler Report reflected conventional think-

ing on the trade openness model, “based on the classic concept that the free play of international economic forces by itself leads to the optimum expansion of trade and the most efficient utilization of the world’s productive resources” (UNCTAD, 1964: 18); its assumption of near equality of initial conditions leading to convergence and common trading interests was inconsistent with the burgeoning literature on economic development. As Nurkse (1959: 26) noted at the time,

In a world in which (outside the Soviet area) over nine-tenths of the manufacturing and four-fifths of the total productive activity are concentrated in the advanced industrial countries, the ideas of symmetry, reciprocity and mutual dependence which are associated with the traditional theory of international trade are of rather questionable relevance to trade relations between centre and periphery.

The point in the international trading system where asymmetries between centre and periphery appeared in sharpest focus was in the terms of trade for primary exports. Empirical studies reported a long-term decline, coupled with high instability, in the terms of trade between primary and manufactured exports. The explanation pointed to price and income inelasticity for the demand of primary commodities. This, combined with competitive market conditions, meant that investment and technical progress, which, in the developed countries, led to higher wages and living standards of those employed, in the developing countries tended to result in lower prices for their exports. The secular tendency for the terms of trade to move against developing countries and especially for those exporting primary products, seriously constrained the capacity of developing countries to import the capital goods needed to accelerate capital formation and to diversify into more dynamic areas of international trade. Given that industrial development offered the best chance of raising productivity growth (through scale economies and innovation), and producing a virtuous growth circle between demand expansion and development of productive capacities, a basic objective of development policy was to find ways of redressing the structural constraints on catch-up growth.¹⁸

Raul Prebisch developed the policy options for countries locked into a pattern of slow growth

and adverse terms-of-trade movements. Already in the mid-1950s as head of the then Economic Commission for Latin America (ECLA), he had organized a series of country studies examining the disappointing results of the inward-oriented industrialization model adopted in Latin America in the inter-war years. A 1956 report on the Argentinean economy prepared under his guidance outlined an outward-oriented growth strategy which aimed for a better balance between agriculture and industrial development, whilst shifting the orientation of industry from domestic to foreign markets to achieve more dynamic scale economies (Rosenthal, 2003: 181–183).¹⁹

Linking trade prospects to a structuralist development model also cast the working of the international trading system in a different light. If the consistent application of liberalization measures through universal trade rules and principles, combined with the gradual absorption of imported technologies, could not be relied upon to eliminate the external imbalances accompanying economic development, or to bring about rapid productivity growth and income convergence along the lines achieved by the late industrializing economies in the late nineteenth and early twentieth centuries, then a rules-based system supportive of an industry-led growth strategy for poorer countries would have to accommodate an element of asymmetrical integration into the world economy. As noted in the Report of the Secretary-General of UNCTAD (UNCTAD, 1964: 19),

The request for reciprocity in negotiations between countries that have no structural disparity in their demands is logical. In the case of trade between the developing and the industrial countries, the situation is different. Since the former tend to import more than they export – owing to the international disparity in demand – concessions granted by the industrial countries tend to rectify this disparity and are soon reflected in an expansion of their exports to developing countries. In other words, the developing economies, given their potential demand for imports, can import more than they would otherwise have been able to do had these concessions not been granted. Thus there is a real or implicit reciprocity, independent of the play of conventional concessions.

Multilateral efforts at designing this new trading geometry culminated in the First UNCTAD

Conference in 1964. The Report to the Conference, entitled *Towards a New Trade Policy for Development*, set out to show that the free play of international economic forces would not by itself lead to the most desirable utilization of the world's productive resources, given the structural obstacles to growth at the domestic and international levels. It also spelt out the implications for trade and related finance if the minimum target of 5 per cent growth for developing countries was to be achieved.²⁰ In specifying what was to be done, the Report rejected both the import substitution model handed down from the inter-war period and the openness model embodied in the GATT. Instead, it spelt out an alternative strategy which would help poorer countries develop outwardly through strong capital formation and continuing and accelerated expansion of exports – both traditional and non-traditional. Central to that agenda was the idea that if developing countries were to rely on their own efforts, they would need to have sufficient policy space to accelerate capital formation, diversify their economic structures and give development a greater “social depth”. There would also need to be a change in the orientation of international cooperation to ensure that this strategy was consistent with the international goal of poverty alleviation (UNCTAD, 1964: 64).

This reorientation would require a much more flexibly managed trading system to accommodate countries at different levels of development. In a sense, a case for greater flexibility had already been accepted by advanced industrial economies in the GATT when they sought more orderly adjustments for their own peripheral areas and sunset activities.²¹ Such flexibilities were provided by non-application of the Agreement between particular Contracting Parties under Article XXXV and the Grandfather Clause, under which original contracting parties to the GATT agreed to apply major obligations of the agreement only to the extent of their consistence with existing national legislation. This was most notably applied in the case of agriculture. Favourable terms were also extended to textiles and clothing, which were eventually accorded their own separate trade regime. Extending

this idea of preferential treatment to industries in developing countries would, however, have to accommodate the wider productivity gaps – due to structural differences and differing technological densities – which existed with the advanced economies. Allowing more favourable access to their markets would be one way to overcome initial cost disadvantages. Additionally, appropriate fiscal support and other incentives for infant industries would be needed, along with supplementary measures, where possible, to ensure a more effectively managed exchange rate. All such measures would have to be carefully monitored and subject to clear bounds in line with improving technological capacities and productivity improvements.

The UNCTAD agenda also addressed the interdependence of trade and finance, given that, particularly in the early stages of industrialization, imports would almost certainly grow faster than exports, and that financing the resulting trade gap would be key to accelerating growth. This would require additional development assistance or compensatory finance for deteriorating terms of trade and debt relief. The Report to UNCTAD I also recognized

The Report to UNCTAD I recognized that any new trade geometry in support of development would hinge on fast and stable growth in the developed countries.

that any new trade geometry in support of development would hinge on fast and stable growth in the developed countries, and that the international financial arrangements would require sufficient resources to prevent disruptive stop-go cycles in those countries. Furthermore, it raised concerns about the adequacy of balance-of-payments financing in light of the growing volume of trade, persistent trade surpluses in some economies, and the need to supplement gold reserves with new instruments to allow for additional credit expansion by international financial institutions.

In the absence of sufficient finance for meeting the structural demands of developing countries, external equilibrium could only be maintained through the suspension of commitments made in the multilateral trading system (Johnson, 1967: 114–115). The GATT had accepted this principle for developed countries in support of the post-war full-employment agenda. For example, Article VII provided for exchange controls and trade restric-

tions when the currency required to finance external imbalances was declared “scarce”.²² This implicit acceptance of the priority of meeting financial obligations over the observance of commitments to free trade was reflected in GATT Articles XII (Restrictions to Safeguard the Balance of Payments) and XV (outlining the terms of GATT and IMF collaboration on exchange rate questions). These exemptions were granted, essentially, to address temporary liquidity problems. Similar exemptions for longer run adjustments, included in the ITO proposals, had not been incorporated into the GATT, and were only seriously considered after the creation of UNCTAD. It was only in 1979 that special and differential treatment was accepted as a general requirement for enabling the beneficial participation of developing countries in the post-war international trading and financial system.

The creation of UNCTAD was part of the post-war reformist wave, which extended the search for multilateral solutions to the economic challenges of an interdependent world to encompass development problems largely ignored at Bretton Woods. Its starting point was the need to address the structural obstacles to catch-up growth, and particularly those enforced through international market forces. Rebalancing the system required a strategic pattern of integration in line with levels of industrial development and favourable terms of market access, as well as appropriate levels of development finance. But just as importantly, as noted by Edward Heath, Head of the British delegation to UNCTAD I, it required that the richer countries begin to see “fuller cooperation and greater interdependence” as common allies in the fight for a more prosperous and fairer world.

D. Interdependence after Bretton Woods

As noted in the previous section, a central feature of the Bretton Woods system was affording sufficient space to policy-makers to meet employment, inflation and growth targets, accepting that, in an increasingly interdependent global economy, policies should be employed with a clear sense of any potential negative externalities they might generate.²³ This was achieved through a system of fixed but adjustable exchange rates, with tight controls on international capital movements along with the global provision of liquidity, enabling countries to pursue expansionary policies that would bring positive externalities for trading partners (Stiglitz, 2003). On this basis, an early Washington policy consensus – articulated by Treasury Secretary Morgenthau and the chief United States negotiator at Bretton Woods, Harry White – allowed for restrictions on destabilizing

capital flows and placed clear limits on the surveillance and conditionality attached to international lending. According to White, as cited in Felix (1996: 64),

To use international monetary arrangements as a cloak for the enforcement of unpopular policies, whose merits or demerits rest not on international monetary considerations as such but on the whole economic program and philosophy of the country concerned, would poison the atmosphere of international financial stability.

This consensus quickly unravelled with the collapse of the Bretton Woods system in the early 1970s, and the transfer of the management of foreign exchange risk to the private financial sector (Eatwell and Taylor, 2000). The collapse was fol-

lowed by the removal of capital controls, and by a move to financial deregulation in the developed economies, which was transmitted swiftly to the rest of the world, in no small part thanks to the efforts of the international financial institutions to lock in “the freedom of capital movements already achieved and encourage wider liberalization” (Camdessus, 1995). These efforts implied a shift in focus from guaranteeing systemic financial stability to catalysing private capital flows by building confidence, including through intrusive adjustment programmes in debt-ridden developing countries.

This change of direction assumes that financial deepening, brought about by the liberalization of domestic financial markets and the opening up of the capital account, would lead to a more efficient allocation of resources and faster and more stable growth.²⁴ The removal of controls over international capital was followed by a marked increase in flows to developing countries, beginning with syndicated bank lending in the mid-1970s, and, since the late 1980s, in equity flows and FDI (*TDR 1999*). This has frequently led to comparisons with the earlier period of rapid globalization under the gold standard, when large private capital flows underpinned strong economic performances, including on the periphery. This parallel implies the presence of a number of features in current arrangements: first, capital flows are predominantly long-term, triggered by productive profit opportunities in an emerging international division of labour, and supported by complementary trade and labour flows; second, stability rests on strong domestic capital accumulation, which is not sacrificed to emerging trade imbalances; and third, short-term capital flows play a subordinate and stabilizing role.

Under the gold standard, such flows and adjustments were managed through a “socially-constructed” monetary arrangement that included a simple set of rules around which core lenders and borrowers could build expectations of a stable future. It also included a willingness to subordinate domestic policy goals in times of crisis; and there was a lead economy with a vested economic

interest in maintaining a stable currency and free trade, even as it was channelling domestic savings abroad.²⁵ Strong States channelled funds into productive public investment, while they used policy space to manage a fast pace of capital accumulation and to encourage exporting that could help service the capital flows needed to cover large trade deficits.

The diversity of economies that make up the contemporary international financial system – at least as measured by income gaps between the main debtors and creditors – is probably greater than under the gold standard (World Bank, 1999). However, the greater part of contemporary financial flows are short term, among the developed countries themselves, and even the greater part of global FDI is accounted for by mergers and acquisitions (M&As) amongst the advanced industrialized countries. On balance, the liberalization of capital movements has had little impact on levels of development finance, and the balance-of-payments constraint of developing countries has not been removed. Moreover, no major region has successfully forged strong linkages between net capital inflows, capital formation and industrialization.

Behind these trends lies an emerging picture of transnational finance (Kregel, 1994), with activities focused on providing hedging on foreign-exchange risk across a diversified international portfolio of foreign assets, and with a greatly expanded capacity to operate in a global market for funding sources, borrowing in any currency and lending in any other currency. While the extent of transnational finance remains the subject of ongoing empirical analyses (Felix, 2001), there has been a trend of de-linking international trade and financial flows. This is most clearly the case with short-term flows, where over 80 per cent of transactions relate to round-trip operations of a week or less, motivated by hedging, arbitrage and speculative considerations. But it is also true of some longer term flows. A significant share of FDI flows has been absorbed by M&As and the increased capacity of transnational corporations (TNCs) to combine financial and locational engineering in

The removal of controls over international capital was followed by a marked increase in flows to developing countries in the 1970s.

international production networks has often produced footloose productive assets and ambiguous effects on balance-of-payments positions (Kregel, 1996b; *TDRs 1999* and *2002*). Moreover, and despite the belief that a more open economic environment with unrestricted capital flows would demonstrate the superiority of markets over government intervention, the period since the collapse of the Bretton Woods system has been marked by an increasing incidence of financial crises (in both developed and developing countries), and their growing virulence in terms of lost output and jobs (*TDRs 2000* and *2001*; Eichengreen and Bordo, 2002).

After the rapid opening up of their economies in the 1980s, many developing countries became increasingly preoccupied with ensuring sufficient flows of external funds, rather than improving domestic resource accumulation and productivity growth. In particular, foreign capital flows were regarded as an instrument for accelerating growth. The monetary conditions created by these flows and the policies to attract them were not considered to hinder domestic investment. It was believed that high nominal and real interest rates, a rather stable nominal exchange rate and fiscal restraint should attract capital inflows and assure foreign investors about the seriousness of policy efforts to leave the legacy of hyperinflation behind. In some countries, domestic monetary policy was completely abandoned, and the exchange rate anchor was supposed to stabilize the price level through competition from cheap imports. In addition, it was expected that the sale of State assets and a reduction of government intervention would improve the overall efficiency of the market system. But, the flip side of this “sound policy approach” was that it directly lowered profits and profit expectations of domestic companies and prevented the profit-investment nexus from evolving. Eventually, the efficiency gains of the pro-market policy could not make good the overall restrictive stance of economic policy and the pressure from foreign competitors.

An imbalanced concentration on sound economic policies to fight inflation, and on “getting

relative prices right” by increasing the efficiency of resource allocation, came at the expense of the overall dynamics of the economy, because macroeconomic prices – the real interest rate and the real exchange rate – were not appropriate to this end. Thus, the necessary conditions to foster productivity growth and to combine international competitiveness with strong growth of domestic demand and company profits were not in place. The “sound macroeconomic fundamentals” did not translate into sound fundamentals capable of producing an environment for firms that was conducive to increasing investment, introducing new technologies and expanding exports.

Macroeconomic policy was successful in fighting and eliminating hyperinflation, but once price stability had been achieved, it did not take account of the fact that, in the global market, competition puts downward pressure on prices via cost competition and the creation of excess supplies; this shifts the balance of risks from inflation and excess demand towards deflation and lack of demand. Under these conditions, the increasing importance of international production chains did not allow the rapid introduction and full exploitation of technology for upgrading domestic industry, because most basic research and the more technology- and skill-intensive slices of the production chain remained in the more advanced economies.

The “consensus” during the 1990s has been that there was no alternative to these orthodox policies. Many observers presumed that interest rates and monetary policy cannot be relaxed without a loss of exchange rate stability, price stability and positive capital inflows. However, the combination of low-income growth, an overvalued exchange rate and high interest rates inhibited investment incentives and the restructuring of the domestic productive sector. It also made

it virtually impossible to meet the conditions required to stabilize or reduce the debt burden relative to national income (as real interest rates remained above real growth rates) in the medium term.

After the rapid opening up of their economies in the 1980s, many developing countries became increasingly preoccupied with ensuring sufficient flows of external funds.

Because considerable emphasis was placed on fighting inflation through the establishment of sound macroeconomic fundamentals, such as fiscal restraint, control of monetary expansion and anchoring of the nominal exchange rate, the negative impact on the sustainability of the external balance was neglected. Although external balances generally improved during periods of declining inflation, this was usually achieved by reducing overall income growth sufficiently to compress imports, rather than by raising exports. This is precisely the opposite of the justification for opening the economy to make trade an engine of growth, more specifically to expand manufactured exports in order to be able to increase imports of capital goods for investment and restructuring. These policies also had an adverse impact on the shift from State-led development to market-led development based on international competition. High interest rates were detrimental not only to the industrial sector, but also to primary commodity producers' attempts to modernize their machinery and equipment. Overvalued exchange rates often gave foreign competitors an absolute advantage that could not be compensated by endeavours at the micro level.

In the presence of free capital flows it has been difficult for many developing countries to avoid overvaluation, whether because of excessive optimism about domestic prospects or because of excessive pessimism about prospects in developed countries. Although the international trading system of rules and regulations has always included clauses that allow countries to opt out of their obligations and commitments to free trade when they are faced with extreme balance-of-

payments difficulties and dangerous declines in their foreign-exchange reserves, these clauses were not applied. Moreover, there were no regulations allowing a country to temporarily opt out of free international capital flows when such flows created excessive movements in exchange rates that had an impact on its external competitiveness and its balance of payments. Measures to keep outflows to magnitudes that are commensurate with a country's ability to maintain external balance have not been part of the rules and regulations of the international trading system and of the international financial system in the post-Bretton Woods era.²⁶

Establishing a virtuous interaction between international finance, domestic capital formation and export growth has proved surprisingly uncommon since the collapse of Bretton Woods.

Overall, establishing a virtuous interaction between international finance, domestic capital formation and export growth has proved surprisingly uncommon since the collapse of Bretton Woods. In developing countries, dependence on external capital flows has led markets to impose a risk premium on domestic interest rates that has reduced the space for domestic economic policy and, in some cases, constrained growth, fixed investment and job creation. As a profit-investment nexus failed to take root, development policies became hostage to maintaining a steady increase in capital inflows and to retaining the confidence of the financial institutions providing them. This is highlighted by Latin America which has exhibited a particularly high foreign-debt-to-export ratio and a greater vulnerability to external shocks (IMF, 2002). Additionally, this combination of forces pushes policy-makers to pursue policies that enhance the short-term ability to pay, but they will pay the price of maintaining the confidence of financial markets in terms of reduced policy space to manage any future shocks (Kregel, 1996b).

E. Interdependence, international collective action and policy space

Pressures for greater openness, particularly in an uncertain economic environment and an era of dynamic structural change, have made it increasingly difficult for countries to pursue their own national policies for development and integration into the global economy. The openness agenda overlooks the fact that the advanced industrial economies engaged in very active economic policies in pursuit of their development, and it ignores their history of building “hard States” to guide that process (see Chang, 2002; and Bayly, 2003).²⁷ Instead, by concentrating on market forces and “getting prices right” to maximize the gains from a given pattern of factor endowments, the openness agenda has perpetuated a lopsided view of the forces driving economic integration. It stresses the potential gains from participation in international markets while downplaying adjustment costs, and it stresses convergence tendencies while ignoring potential sources of cumulative divergence.

As the previous sections have suggested, this approach has its limitations. Trade is just one among several interrelated factors shaping integration. Its impact is largely contingent on the presence of dynamic forces – specialization, learning and innovation, scale economies and capital formation – that do not respond in a simple or predictable way to the incentives generated from rapid opening up. Strengthening these forces requires a series of complementary institutional

reforms and discretionary macroeconomic, industrial and social policy measures. This implies considerable diversity in the pattern of integration, even among countries at similar levels of economic development.

Development strategies that successfully harness trade to a strong growth dynamic will necessarily lead to closer links with the wider international economy, especially with neighbouring economies. This will make the success or failure of those strategies increasingly dependent on

trends and policies elsewhere. Moreover, as more countries establish successful growth regimes, an expansion of trade will be accompanied by increased cross-border flows of investment, technology and finance. As a result, a country’s “internal performance”

(as measured by investment levels, productivity growth, employment creation and technological upgrading) and its “external performance” (as measured by the trade balance, net capital flows and exchange rate stability) become much more closely intertwined and the policy trade-offs considerably more challenging.

It is unlikely that the policy trade-offs will ever be satisfactorily resolved by privileging external goals, even as countries seek to maximize the benefits from closer participation in the international division of labour. Rather, stability will depend, in part, on the ability and willingness of

Trade is just one among a number of interrelated factors shaping integration.

individual countries to pursue policies that are compatible not only with their own national objectives, but also with the objectives and policies of other countries. It is therefore necessary to find common objectives among countries at varying levels of development around which a stable pattern of integration can be built.

The openness agenda has sought consensus around common policy instruments and universal price incentives. However, experience shows that there is a need for policy instruments specifically designed with the aim of helping countries at lower stages of development to converge on the levels of efficiency and affluence achieved by the more advanced economies, and to improve the welfare of all groups of the population. Making this the principle for policy design at both the domestic and the international level requires recognition of the fact that successful development and integration of the developing countries is in the mutual interest of all countries, as longer-term growth and trading opportunities of the more advanced economies also depend on the expansion of industrial capacity and markets in the poorer economies.

Under the gold standard, unprecedented private capital and labour flows helped establish mutually beneficial linkages between a wealthy industrial core, primary exporters and a small group of late industrializing economies. And even though the economic gap was relatively narrow, the latter were free to establish industrial capacity behind high and enduring levels of tariff protection, while exporters were allowed unrestricted access to the markets of the industrial core. The openness agenda during the inter-war period failed to strike the right balance between market forces, policy space and collective international action. Later, under the Bretton Woods system, both private capital flows and the movement of labour were sharply curtailed, but policy space was extended to allow both developed and developing countries to pursue a broad economic agenda, and an institutional framework was set up for collective international action in support of growth and stability and for managing economic integration.

As discussed earlier, this required a degree of flexibility in the workings of those arrangements in recognition of the differences in initial conditions and the varying pace of economic and industrial progress.

In today's world of increased interdependence dealing with the trade-offs between domestic and external objectives requires a much more pragmatic approach to policy-making than that suggested by the openness agenda. In the absence of easy growth and adjustment formulas for economic catch-up through industrialization, strategies that seek to make convergence a common policy objective have to allow a good deal more room for experimentation and discrimination in favour of countries with lower efficiency and income levels. To this end, policy-makers need to adopt a more pragmatic "rule of thumb" approach to designing useful interventions consistent with the practical world of politics (Krugman, 1987).

Since developing countries have become more vulnerable to external shocks, and the potential costs of adjusting to those shocks are significant and unevenly distributed, there is a danger that countries will try to use their available policy space to solve economic problems

at the expense of other countries through "beggar-thy-neighbour" policies. Accordingly, much like integration at the national level, which requires arrangements to ensure that all regions and social groups benefit from growth, efforts to bring progress, stability and predictability to an increasingly interdependent world also have to involve more collaborative and cooperative arrangements among countries.

As more countries seek to build domestic productive capacity and potential conflicts and rivalries increase, success in moving towards more open multilateral economic arrangements implies more than aiming at agreements dealing with reductions of tariffs, quotas and subsidies, and other impediments to the expansion of trade. And attracting more FDI is not a substitute for rapid domestic capital accumulation. Rather, the entire

The entire international economic system must be capable of supporting growth and convergence across a wide spectrum of countries making up the international division of labour.

international economic system should be capable of supporting growth and convergence across a wide spectrum of countries making up the international division of labour, with appropriate flexibilities built in to accommodate the diversity of conditions. Currently, only a handful of States are sufficiently large and dynamic enough to harness international forces to economic objectives, and even fewer are able to dictate the terms of integration and, consequently, to influence the prospects of other countries. Under such conditions, a critical ingredient of stable multilateralism is that the leadership of the strongest participants must be oriented in the right direction (Kindleberger, 1986).

Not only are the leading economies in a better position to bear the short-term costs of the collective actions needed to guarantee the long-term health of a more interdependent economic system, they also have an asymmetric bearing on growth prospects in the weaker economies through their share in world demand, their level of technological development and control over capital. They therefore have the added responsibility of pursuing policies in a way that does not damage the growth and stability of the weaker economies. Of particular concern are the potentially destabilizing and deflationary feedbacks between trade

The search for economic stability is not between autarky and surrendering national sovereignty to the expansive logic of markets.

and finance, which often create impediments to development. Financial crises in the developing countries frequently result, at least in part, from various shocks and policy changes that originate in the major reserve currency countries. But at present, there is no system of multilateral surveillance that can insist on greater coherence in the latter's monetary and exchange rate policies. In the absence of more balanced representation in multilateral institutions, there is a need for arrangements that make it possible to accommodate the kind of discretionary policy action on the part of countries at lower levels of efficiency and income that was an important ingredient of the successful integration of the more advanced economies into the international economy.

Thus, contrary to the thrust of the openness model, the search for economic stability and balance is not between autarky and surrendering national sovereignty to the expansive logic of markets. Nor does the latter provide the institutional standard against which development success should be judged. Rather, in an interdependent world, the balance between economic welfare at the national level and integration at the international level will continue to hinge on an appropriate mix of market forces, policy space and collective actions. ■

Notes

- 1 A recent review of the voluminous body of modelling exercises, country studies and regression analyses, all reporting a strong link between increased trade openness and economic welfare (both positive and negative), concludes that the whole case has been “exaggerated” (Freeman, 2003). For a review of the evidence see Kozul-Wright and Rayment, 2004.
- 2 For more on the profit-investment nexus in the development process, see *TDRs 1996 and 1997*; Amsden, 2001; and Ros, 2002.
- 3 Economic development is complicated by social and political changes, particularly where this involves the separation of large numbers of people from the land and their growing concentration in urban centres, and by the steady, albeit punctuated, rise of democratic institutions; for a seminal discussion, see Polanyi, 1944; and Moore, 1966.
- 4 The literature describing this history is vast; see, for example, Rowthorn and Chang, 1993; Reinert, 1999; Gomory and Baumol, 2000; and Bayly, 2003.
- 5 Over 40 per cent of the French labour force was in farming, and the figure was even higher on the European periphery and in the white-settler colonies. Even in the United States, where total farm mortgages had risen from \$3.3 billion in 1910 to \$9.4 billion in 1925, the agricultural sector accounted for a quarter of total employment and farm exports for over one quarter of farm incomes. With slower growth, weak international prices and protectionism in some leading markets, the burden of external debt-servicing rose steadily for most primary exporters in the 1920s (Kindleberger, 1987: 84–87).
- 6 According to Bairoch (1993: 4–5), the weighted average of customs duties on manufactures in continental Europe was 24.6 per cent in 1913 and 24.9 per cent in 1927, and the figures were almost certainly lower in 1928 and 1929. As Bairoch notes, however, there was plenty of variation around these average figures, as was the case before 1914.
- 7 Germany returned to its pre-war parity in 1924 as part of the Dawes Plan, and the United Kingdom a year later. Much of the debate in the United Kingdom at the time, and since, has been about whether prices had reached a level that justified returning to parity with the dollar. However, the return to pre-war parity was not motivated by trade considerations, but was part of the confidence-building exercise needed to restore London as the centre of international finance. In the changed post-war trading environment, and given the failure to re-establish an export-based investment-profit nexus, the consequence was that a growing share of the United Kingdom’s invisible earnings were absorbed by trade deficits, resulting in sharply reduced current account surpluses which failed to cover long-term security issues on London capital markets. Its need to resort to short-term borrowing to close this gap became its Achilles’ heel once the gold standard was restored.
- 8 This also allowed some room for a degree of counter-cyclical monetary policy (Kenwood and Loughheed, 1994: 113–115).
- 9 This term is derived from an investment swindle, whereby investments are pocketed and interest or profits are paid to investors out of new money flowing into the scheme.
- 10 This had been a familiar situation in peripheral economies under the gold standard, where erratic export earnings and doubts about the commitment to stay on gold could bring capital flows to a rapid halt and spark financial crisis. However, when shocks did occur on the periphery they were isolated and relatively easy to contain (Eichengreen and Bordo, 2002).
- 11 Strictly speaking GATT and ITO discussions were parallel negotiating tracks under the auspices of ECOSOC. The former was in fact the first to kick off, involving 23 countries, guided by the United States Trade Agreements Act of 1934 which allowed

- the United States Administration to negotiate reciprocal tariff reductions with other countries. The first session was successfully concluded in Geneva in 1947. It was presumed GATT would apply until the full ITO was concluded. Meanwhile, although international commodity schemes disappeared from the agenda, grants of commodities (produced predominantly in the United States) represented a significant component of the European Recovery Programme (Kenwood and Lougheed, 1994: 242).
- 12 This was helped by a degree of forced policy realism after sterling convertibility linked to the Anglo-American Financial Agreement ended in suspension in 1949, opening the way to a more general wave of devaluations to accommodate balance-of-payment distortions. The start of the Korean War in 1950 also acted as a timely global stimulus.
- 13 The majority of the 28 developing countries present were small South American economies; India and South Africa were still formerly under British rule and Egypt and Iraq were closely aligned; Cuba, Liberia and the Philippines were closely aligned to the United States. The protocol to implement the GATT was signed by 53 countries with a greater developing-country weight.
- 14 It is also worth noting that the World Bank lacked a mandate to deal with debt rescheduling or the management of capital flows, both potentially important concerns for developing countries.
- 15 Kenwood and Lougheed (1994: 254) estimate that between 1945 and 1960 around \$26 billion were granted in aid to developing countries (i.e. less than \$2 billion annually).
- 16 One of the first to voice this concern was Brazilian President Getulio Vargas in 1951, who complained that Brazil had experienced a negative net capital flow continuously from 1939 (with the exception of 1947) (Kregel, 2004). For further information on the structuralist approach, see Palma, 1989; and Rosenthal, 2003.
- 17 The Report led to a number of institutional changes in the GATT aimed at better addressing the concerns of developing countries, see Kenwood and Lougheed (1994: 276).
- 18 The empirical debate on the movement in the terms of trade has been running for some time, and the pre-war evidence on which Prebisch (and separately Hans Singer) built his initial argument is still a subject of dispute. For critical assessments of the early evidence, see Johnson, 1967; Bairoch, 1993; and Spraos 1980. More recently, Hadass and Williamson (2001) and Blattman et al. (2003) have taken a more favourable view of the Prebisch-Singer data; see also *TDR 2002*.
- 19 James (2000: 145–158) provides an interesting comparison of the divergent performance of Argentina and Brazil in the 1930s and Prebisch's own experience therein, which, at the time, cast him as an opponent of import substituting industrialization (ISI). On Prebisch's contribution and its distortion by mainstream trade theorists, see the various papers in ECLAC, 2001.
- 20 The Report's structural emphasis was complemented by a historical perspective, showing how structural growth forces had interacted differently in different periods: in the nineteenth century, when a resource-scarce and free-trading United Kingdom exported manufactures in exchange for food and raw materials from the periphery; in the inter-war period, dominated by a resource-rich and protectionist United States and by the collapse of trade following the Great Depression, growth followed a more inward orientation; and in the contemporary multilateral era, dominated by a rapidly modernizing Europe, openness and the application of reciprocity and mutual dependence reinforced first-mover advantages while it subjected late-comers to the problem of mounting indebtedness.
- 21 On the nature of managed trade under the GATT, see *TDR 1984*: 70–75; and Cornford, 2004.
- 22 The concept of currency scarcity was embodied in the IMF Charter, which allowed for its management under certain circumstances (Article VII. 3a, b and c).
- 23 Unlike the management of trade relations, where opinion over the choice of policies and institutions was quite sharply divided after the war, the failure of financial markets to prevent currency disorders and contagion in the 1930s was widely accepted as the basis for putting in place multilateral financial arrangements (Nurkse, 1944).
- 24 Much like the literature on the links between trade liberalization and growth, there has been a shift in emphasis from the direct benefits to growth from financial liberalization – which have proved difficult to detect – to the indirect benefits in terms of raising institutional quality (King and Levine, 1993; Prasad et al., 2003).
- 25 The extent of British dominance of the international financial system was unprecedented, not only relative to other financial centres but also relative to the United Kingdom's own domestic investment, when at times, in the early 1900s, it was investing a higher proportion of savings abroad than at home.
- 26 For much of the Bretton Woods era, under fixed exchange rate regimes and capital controls, the accumulated stocks of external sovereign debt remained very low, and the majority of capital flows involved direct investments. This could still give rise to a benign form of speculative financial fragility covered by official development assistance (ODA), although this appears to have been uncommon. Under these conditions, devaluation was equivalent to a partial default on debt service to non-resident holders of domestic assets. However, after the col-

lapse of this system in 1973, default on domestic-currency-denominated external commitments became acceptable in the form of flexible exchange rates, with the risk of default shifting onto the individual borrower.

27 The contrast between “hard” and “soft” States in the development process was first made by Gunnar Myrdal.

FOSTERING COHERENCE BETWEEN THE INTERNATIONAL TRADING, MONETARY AND FINANCIAL SYSTEMS

Developing countries depend on a favourable international trading environment to reap the full benefits of their integration into the world economy. Equally important for their successful integration is the creation of strong supply capacities. An essential lesson from the experiences of countries that combined successful integration into the world economy with sustained growth is the critical role of active and well sequenced policies to augment the existing stock of physical and human capital, enable the use of more efficient technologies, and shift resources from traditional, low-productivity activities towards activities that offer a high potential for productivity growth.

This chapter examines the problem of insufficient coherence between the international trading, monetary and financial systems, and how it affects the formulation and successful implementation of national development strategies. It is argued that rapid financial liberalization, inasmuch as it makes developing countries vulnerable to sharp and abrupt shifts in the direction of largely autonomous short-term private international capital flows, can have negative effects on their trade performance. As demonstrated by the Asian cri-

sis, such vulnerability can arise even in countries with sound macroeconomic and external positions, and can contribute to problems in managing interest rates and exchange rates. Managed currency depreciations, proceeding on a smooth, long-term basis, can strengthen the international cost competitiveness of domestic exporters and generally improve developing countries' trade performance. However, this is not the case for the sharp and abrupt exchange rate depreciations that have occurred in many financially open developing countries over the past three decades; they did not result in proportionally larger improvements in trade performance. This is because they were often accompanied by sharp declines in imports and reduced access to trade finance and working capital, which compromised the ability of domestic exporters to benefit from their increased international cost competitiveness stemming from the depreciation. Finally, the chapter draws some conclusions on how developing-country policymakers can avoid a situation where insufficient coherence in the international monetary and financial system jeopardizes the successful implementation of national development strategies designed to foster domestic supply capacities.

A. Building the international competitiveness of developing-country exporters

Historical evidence shows that countries raise the standard of living of their populations by raising labour productivity. This is associated with a substantial change in the sectoral pattern of production and employment, from agricultural to industrial products, and a shift from labour-intensive activities to a growing range of capital- and technology-intensive activities. As discussed in *TDR 2003* (chapter V), the production structure of an economy is of key importance for the development process, because, at any point in time, both the level of productivity and the potential for technical progress and productivity growth vary significantly across agriculture, industry and services, as well as within these sectors. The pace and scale of economic development varies substantially across countries. Many factors account for this diversity in performance, which, apart from a number of structural elements (such as resource endowments, economic size and geographical location), include variables that are susceptible to policy influences and choices. Of paramount importance among these variables are the pace and innovativeness of capital accumulation, human capital formation and the international competitiveness of domestic exporters.

Transformation of the production structure requires entrepreneurs who are capable and willing to invest in activities that are new to the domestic economy. Indeed, Schumpeter (1911) pointed to the importance of innovative investment for economic development, and Baumol (2002) argues that innovation, and the consequent rise in productivity, account for much of the ex-

traordinary growth record that has occurred in various parts of the world since the Industrial Revolution. He suggests that market pressures arising from oligopolistic competition force firms to integrate innovative investment into their routine decision processes and activities – thus, the innovation process is neither largely autonomous nor largely fortuitous. Market forces achieve much of this through financial incentives, by providing higher pay-offs to those firms that are more efficient and whose products are most closely adapted to the wishes of consumers.

However, the occurrence of innovative investment is not automatic; it could encounter structural and institutional impediments. Moreover, the macroeconomic environment could be inappropriate for encouraging and supporting investors seeking to create or expand productive capacity and, in particular, to increase productivity and international competitiveness. The main incentive for investors to discover a more efficient way of producing an existing good or to produce a new good arises when they can appropriate at least part of the rent generated by the creation of new knowledge. Within this framework, for an innovative entrepreneur to enjoy such benefits, a number of conditions must apply at different levels, as discussed in detail in annex 1 to this chapter.

Entrepreneurs invest in the industrial sector of that country in which they expect to realize the highest return on their investment. Cross-country differences in the expected return on investment, expressed in a common currency, are determined

by a number of factors, including relative rates of income growth; relative wages and labour productivity; macroeconomic and institutional factors that influence the average level of nominal labour costs in an economy as a whole; relative costs of intermediate production inputs; relative transaction costs associated with information, communications, transportation and distribution; and the use of different currencies. Moreover, market access and entry conditions and the availability of trade finance also determine whether improved cost competitiveness translates into improved export performance. This shows that a wide range of conditions must combine for firms that are competitive on the domestic market to become successful exporters.

First, the availability of adequate transport and communications infrastructure and information systems has a crucial influence on the ability of developing-country firms to conduct trade and to successfully compete in foreign markets.¹ Innovative investors in economies with comparatively high communication, transport and information costs may need to offset this disadvantage by paying lower wages or reducing costs elsewhere in the production process in order to be able to compete in world markets. Firms in countries that are landlocked or geographically distant from major international shipping routes are particularly disadvantaged in this respect. While this is a well-known problem, the impact on trade flows of other forms of trade facilitation, such as the availability of networked information technology and compliance with product standards, has gained in importance over the past few years.

Second, trade finance provides the liquidity for firms to bring their products to the market. Exporters with limited access to working capital often require credit to buy imported raw materials and intermediate production inputs, as well as financing to manufacture products before receiv-

ing payments. Trade finance may be provided directly through loans from commercial banks, prepayments by buyers, and delayed payments by sellers, or indirectly from either export-credit agencies (in the form of guarantees, insurance and government-backed loans), private insurance companies, or multilateral development banks.

Third, assuming constant nominal exchange rates, preserving the international cost competitiveness of domestic firms requires that the ratio of average nominal labour cost growth to average domestic productivity growth in the domestic economy does not rise faster than in the rest of the world. Macroeconomic and institutional factors play an important role in fulfilling this condition. For example, the pressure for sharp general wage increases in an economy approaching full employment is likely to be higher than in an economy with substantial unemployment. Moreover, indexation of wage rises based on factors other than productivity growth is likely to cause substantial and lasting divergence between wage and productivity developments.²

Fourth, stable nominal exchange rates are perhaps the single most important condition for the transmission of domestic productivity improvements to gains in international competitiveness. Exchange rate movements alter the relative competitive position of firms in different countries. On the one hand, this implies that a currency appreciation will wipe out improvements in international competitiveness achieved by innovative firms on the basis of improved labour productivity if the change in the exchange rate exceeds the gain in pro-

ductivity. If technological progress relies on cumulative and incremental innovations that individually lead to comparatively small productivity gains, it does not take exchange rate changes of a spectacular size for this to occur.³ On the other hand, this implies that currency depreciation can

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give a further boost to the international competitiveness of an innovative firm and maintain the relative competitive position of non-innovative enterprises in the short run. However, there can be little doubt that long-term economic success and maintaining international competitiveness depend

on sustained improvements in productivity. Moreover, resorting to currency depreciation may allow for some breathing space to adjust to changes in the relative competitive position of foreign competitors, but it also entails the risk of igniting a process of competitive devaluations.

B. Impacts of monetary and financial factors on developing countries' export performance

Only productivity growth and technological upgrading can ensure sustained improvement in the external balance of developing countries. This can be achieved by a national development strategy that is successful in augmenting the existing stock of physical and human capital, enabling the use of more efficient technologies, and shifting resources away from traditional, low-productivity activities towards activities that offer a high potential for productivity growth. Under some circumstances, and particularly when a period of real currency appreciation has hampered export performance, real currency depreciations can improve international cost competitiveness and boost exports.

The exchange rate has long been recognized as an important policy instrument to make domestic entrepreneurs internationally competitive and provide profit incentives for them to invest in non-traditional export sectors. For example, according to Agosin and Tussie (1993: 22) "The historical record ... shows that ... [a]ll countries that have succeeded in generating a sustained growth of their exports, leading to high rates of growth of output over the long term, have also been able to maintain exchange rates that are attractive to exporters over long periods of time. The exchange rate in such countries has also tended to be fairly stable,

enabling producers of tradeables to make long-term investment plans." In a similar vein, Rodrik (2003) argues that countries grow rich by increasing the range of products that they produce, and not by concentrating on what they already do well. Product diversification requires entrepreneurs who are willing to invest in activities that are new to the local economy, and that process may require positive inducements. Rodrik (2003: 21) concludes that "a credible, sustained real exchange rate depreciation may constitute the most effective industrial policy there is."

For successful trade performance, developing countries need to be able to manage their exchange rates in a way that allows them not only to sustain competitive rates over the longer term, but also to retain enough policy space to be able to make orderly adjustments when faced with exogenous shocks. On some theoretical accounts, a regime of freely floating exchange rates and free capital mobility would enable nominal exchange rate movements to stabilize real exchange rates. This argument is based on the premise that movements of the nominal rates eliminate temporary disequilibrium in the pricing of goods in different currencies, and that arbitraging currency speculators speed up the adjustment, thus helping to maintain a correct set of real prices on which in-

international traders and speculators can base their decisions (see, for example, Friedman, 1953).

Floating exchange rates between the main reserve currencies were introduced into the international system of trade and finance in the early 1970s. However, orderly balance-of-payments adjustments, increased real exchange rate stability, greater macroeconomic policy autonomy and removal of persistent currency misalignments and gyrations have not been achieved. This is partly due to the liberalization of capital flows in the last 30 years and to the sizeable increase in the scale and variety of cross-border financial transactions, whose direction can change rapidly in response to shifts in expectations of international portfolio investors. As a result, the currencies of the major developed countries, as well as those of financially open emerging-market economies, have been subject to strong volatility and gyrations, which often represent endogenous responses to large and sharp changes in the direction of international financial flows. These developments are reminiscent of the failure of financial markets to prevent currency disorders and contagion in the 1930s (an insight that was widely accepted as the basis for the attempt to put in place multilateral financial arrangements after the Second World War).

For developing countries, capital inflows, both private and public, can be a source of development finance. However, volatility in international financial markets, and particularly sharp and abrupt shifts in the direction of largely autonomous short-term private capital flows, have frequently contributed to problems in managing interest rates and exchange rates, and to financial crises including in countries with track records of macroeconomic discipline. Since the early 1990s, a number of developing countries, particularly those that had begun liberalizing their financial markets, have experienced substantial movements in their exchange rates. These movements have frequently been characterized by prolonged periods of exchange rate appreciation followed by abrupt and sharp devaluations, often associated with a sizeable slowdown in economic activity.

These episodes of sharp and abrupt currency depreciations include the well-known currency crises when countries abandoned pegged exchange rates, starting with Mexico in 1994, followed by East Asia (1997–1998), the Russian Federation (1998), Brazil (1999), Turkey (2001) and Argentina (2002). There were also instances of unusually sharp depreciations in countries with more flexible exchange rates, such as Mexico and South Africa in 1998.

The sharpness of recent real currency depreciations brings an additional dimension to the debate on the effect of exchange rate changes on trade flows.

The scale of nominal exchange rate depreciations in many developing countries – even those with a record of macroeconomic discipline – over the past few years has often caused large real exchange rate depreciations. Given that real currency depreciations can generally be expected to improve a country's trade balance, it could be assumed that sharp depreciations of the real exchange rate will provide an even greater impetus to the international cost competitiveness of domestic exporters and a boost to a country's exports.

The main argument of this section is that the sharpness of recent real currency depreciations brings an additional dimension to the debate on the effect of exchange rate changes on trade flows. This is because, in the short term, large depreciations of the real exchange rate can seriously compromise the ability of domestic exporters to benefit from their increased international cost competitiveness stemming from the depreciation. Adverse effects occur at two levels. At the level of individual enterprises, it can take the form of a sharp decline in the availability, and/or a strong rise in the cost, of trade finance and working capital. At the macroeconomic level, close trading relationships can provide a channel for the transmission of financial crises and raise the risk of competitive devaluations, which can offset the rise in demand for exports created by the depreciation. Moreover, the steep decline in economic activity, often associated with sharp and abrupt real currency depreciations, can have an adverse effect on the supply of exports. Such depreciations tend to violate two of the conditions necessary for domestic productivity growth to translate into sustained international competitiveness: access of

firms to reliable, adequate and cost-effective sources for financing their investments and stable nominal exchange rates at a level that does not impair the international cost competitiveness of domestic exporters. This section examines more closely the impact that the absence of these two conditions is likely to have on developing-country trade performance.

1. Impacts of exchange rate changes on enterprise investment and competitiveness

Uncertainty in currency markets adversely affects many types of economic activities, particularly those that require forward planning and involve decisions that are only reversible, if at all, at high cost. Long-term investment by enterprises in export production capacity is a noteworthy example of such activities, particularly when their production process utilizes imports from third countries. Consider a production unit whose output would be sold in, for example, the United States for dollars, and which would utilize machinery and equipment purchased from Germany, partly on credit denominated in euros, with intermediate production inputs from Japan denominated in yen, and domestic labour remunerated in domestic currency. In such cases, the estimated rate of return on the investment project would be sensitive to the relative exchange rates between the currencies in which the output is to be sold, the currencies in which imported machinery, equipment and intermediate inputs are invoiced, and the domestic currency. The greater the range of exchange rate variation, the greater is the risk of the project. The project may be profitable only under a given configuration of exchange rates. As a consequence, the investor will realize an extra profit if the exchange rate configuration evolves favourably, but risk bankruptcy in the opposite case. Firm size and financial strength, diversification of operations across products and markets, managing assets and liabilities in different currencies, as well as the use of other risk management techniques, can limit exchange rate risk. But these measures entail additional costs and do not provide complete protection.

Monetary factors in the form of nominal exchange rate changes can thus have a major impact on enterprise investment and international competitiveness. The form and strength of this impact depends on a variety of factors operating through two channels: (i) marginal cost, where the impact partly depends on the firm's ratio of imported to domestically sourced production inputs, the share of financing denominated in foreign currency, and the impact of exchange rate changes on domestic monetary conditions; and (ii) a possible mark-up of price over marginal cost. These factors can pull in opposite directions, and their relative strength can change with the length of time that elapses after the exchange rate change. Moreover, they affect the instruments that firms can use to foster international cost competitiveness in a sustainable way (i.e. making productivity-enhancing investment) and to fend off temporarily adverse influences on their competitiveness (i.e. accepting a profit squeeze or resorting to wage suppression or labour shedding).

(a) The cost channel

Regarding production costs, depreciations of the domestic currency lower the cost of domestic inputs and increase the cost of imported inputs. However, an enterprise can postpone the depreciation-induced price increase of imported inputs measured in domestic currency until it needs to rebuild its stock of such inputs.⁴ Moreover, this effect is reduced if the foreign producers of imported machinery and intermediate goods respond to the depreciation of the domestic currency by lowering their prices denominated in domestic currency.

Empirical evidence supports the argument that large depreciations increase the cost of imported inputs relative to other factors of production. Using input-output tables for Argentina, Chile, Mexico and the Republic of Korea, Burstein, Neves and Rebelo (2004) show that nominal exchange rate changes have a much larger impact on prices of capital goods than consumption goods, and that this impact is strongest for tradable capital goods. Given that developing-country firms import a large share of their machinery and equipment, an increase in the cost of imported

capital goods is likely to have an adverse effect on investment dynamics, and hence on the firm's path of technological upgrading.

In addition to their effect on production costs, adverse impacts of sharp currency depreciations can render it difficult, if not impossible, for firms to obtain financing to increase productive capacity or even to obtain enough working capital to purchase the inputs necessary for maintaining production at pre-depreciation levels. Depreciations have an adverse effect on the financial position of firms, in particular when companies borrow abroad and have high unhedged debt exposure in foreign currency. In this case, sharp depreciations have balance-sheet effects, increasing the relative burden of repaying existing foreign-currency debt, and make the substitution of domestic for foreign sources of financing more onerous. Moreover, depreciations increase the cost of new loans as they reduce collateral values.

A growing concern for a number of developing countries is to ensure that, in the aftermath of sharp currency depreciation, reliable trade finance is available at an adequate level, a reasonable set of conditions and cost. According to a recent study (IMF, 2003: 17–18), bank-financed trade credits declined by as much as 30 to 50 per cent in Brazil and Argentina in 2002, by about 50 per cent in the Republic of Korea in 1997–1998, and by over 80 per cent in Indonesia during the Asian crisis; sharp declines in trade finance were also observed in the Russian Federation, the Philippines and Thailand in 1997–1998, and in Turkey in 2000–2001. The provision of short-term credit for trade financing has traditionally been considered a routine operation, because it is secured by contracts for the sale of goods that earn foreign exchange. Since this represents an implicit hedge for both the borrower and the lender, the default rate on this category of financing has been low. Thus the scale of the decline in trade finance seems to be disproportionate to the

Sharp currency depreciations can render it difficult for firms to obtain financing ...

... to increase productive capacity and take advantage of lower dollar export prices ...

level of risk. Most importantly, a sharp decline in trade finance seriously compromises the ability of firms involved in foreign trade to maintain their investment, production and trade activities. As a result, this loss of financing may offset the stimulus for export expansion stemming from the currency depreciation.

During the years prior to the Asian crisis of 1997–1998, trade finance to developing countries rose sharply, with commitments from commercial banks increasing the fastest (World Bank, 2004: 128). This change in the composition of trade finance partly re-

flected the overall surge in commercial bank lending to developing countries until 1997, and the shift in such lending away from long-term finance, now predominantly provided by bond holders, towards short-term finance. As discussed in some detail in previous *TDRs*, supply-side factors, such as the emerging widespread availability of derivative instruments and the recession-related adoption of low interest rates by the major developed countries, were an important driving force behind this surge in short-term bank lending in the early 1990s. Financial liberalization, along with relatively high domestic nominal interest rates and comparatively stable nominal exchange rates, made a number of developing countries attractive locations for capital flows that were driven by short-term arbitrage motivations.

At the same time, documentation requirements for trade financing loans by commercial banks sharply declined. Given that an increasing share of world trade has been associated with international production networks and their often relatively long-term trading relationships, the share of commercial-bank trade-financing transactions relying on traditional documentary procedures (such as letters of credit) fell from about 90 per cent of all transactions in the late 1980s to about 30 per cent in the late 1990s (World Bank, 2004: 129–130). The less cumbersome, and often less costly, trade financing relationship, mostly

with foreign commercial banks, became increasingly attractive for export-oriented domestic firms also when these firms' export earnings represented an implicit hedge against foreign-exchange risk associated with borrowings in foreign currency. Thus, as happened in the build-up to the Asian crisis (*TDR 1998*: chapter III), assuming relatively stable exchange rates and sustained high export growth, generally, neither exporting firms nor their creditors consider it necessary to explicitly hedge credit risk due to currency fluctuations.

Views differ among market participants as to which factors were predominantly responsible for the shortages of short-term finance during recent currency crises, as discussed by Auboin and Meier-Ewert (2003: 6–8). However, there is widespread agreement that supply-side factors were primarily responsible for the sharp decline in trade finance. For example, international banks – the primary sources of trade credit to emerging markets – engaged in herd behaviour, characterized by a general withdrawal from all lending to developing countries. Their rush to exit was based on an assessment of economy-wide prospects, rather than of the financial conditions of their individual corporate clients. As a result, the majority of international banks, confounding country risk with credit risk, limited their overall exposure to the crisis-ridden markets, rather than maintaining a selective presence on the basis of the true risk profile of their clients.

It is likely that the reduced documentation requirements for trade finance, discussed above, have made it more difficult for commercial banks to distinguish between trade finance and other types of short-term finance. These changes largely explain the uncertainty among international lenders about the continued creditworthiness of domestic firms and about whether crisis-affected countries would continue granting reimbursement priority to trade credit over other types of short-term financing. Indeed, as noted by the World Bank (2004: 14): “One reason that trade credit was not always afforded differential treatment in the 1990s was that the easing of capital controls (under

which trade finance transactions often enjoyed preferential access to scarce foreign exchange) and the movement away from detailed documentation requirements underlying trade finance transactions have blurred the lines between trade credit and other forms of short-term financing.”

Domestic lenders may not be in a position to offset the sharp decline in the provision of trade finance from international banks because of adverse changes in domestic monetary conditions. A common feature of most of the recent large depreciations, and especially currency crises, is that they were accompanied by a contraction in domestic lending and/or a sharp increase in domestic interest rates. In some cases, the contraction in lending was a market response to the capital outflows that generated the currency depreciation. In others, the increase in interest rates was a policy

response designed to reverse capital outflows, halt the depreciation of the currency's value and reduce expenditure imbalances between imports and exports.⁵ Furthermore, some of the measures introduced to strengthen the financial system, such as the imposition of stringent capital requirements on banks, have tended to seriously reduce the

availability of domestic credit. Evidence from the Asian crisis, for example, suggests that currency depreciation inflicted much less damage on firms than the rise in interest rates and cut-backs in domestic credit lines, because many firms with large foreign indebtedness were export-oriented (Choi and Kang, 2000). If credit lines had been maintained, greater competitiveness and growing export revenues would have provided a cushion against the rise in liabilities, measured in domestic currency, caused by the currency depreciations.

The above discussion documents the adverse effects on enterprise investment and international competitiveness that monetary factors originating in other countries can have. Perhaps most importantly, it shows that sharp currency depreciations have effects that can seriously compromise the ability of domestic exporters to take advantage of their increased international cost competitiveness stemming from the depreciation.

... or even to obtain enough working capital to purchase the inputs necessary for maintaining production at pre-depreciation levels.

(b) The profit channel

Regarding profits and sales prices, the impact of large changes in nominal exchange rates on enterprise investment depends on the firm's price-setting strategy and the persistence of the exchange rate change. Firms that set sales prices in foreign markets by adding a mark-up on domestic unit labour costs can temporarily insulate their competitive position from adverse movements in nominal exchange rates, if they limit the exchange rate pass-through into sales prices denominated in foreign currency. In other words, a strategy of "pricing to market" (i.e. discriminating between destination countries by setting different prices on different markets) allows exporters to maintain their price competitiveness even in the aftermath of an exchange rate appreciation. Exchange rate pass-through is complete when the exporter allows prices denominated in foreign currency to adjust entirely in line with exchange rate variations, while there is no pass-through if prices measured in foreign currency remain stable and the exchange rate change is absorbed entirely by a fall in profits.

However, individual firms can use pricing to market only for a limited period of time, because such a strategy has adverse effects on company profits. By using incomplete exchange rate pass-through in order to defend price competitiveness in the short run, firms expose themselves to a high degree of variability in – or even a complete loss of – their profit margins, which is likely to depress investment, and thus adversely affects competitiveness in the long run. This means that if a currency appreciation persists, firms may eventually have to give up pricing to market and transmit the appreciation into higher foreign-currency-denominated sales prices; this would, however, entail the risk of losing their market shares.

Pricing-to-market strategies reduce the visible impact of exchange rate changes on trade

flows. The question therefore arises as to how common is their actual use. Cross-country differences in strategic pricing behaviour are likely to reflect differences in the industry composition of exports, because high-technology-intensive differentiated products, which are typically produced in developed countries, provide more scope for price discrimination. Thus, systematic empirical evidence on the use of pricing to market is limited to exporters of large developed countries, indicating that "in many cases half or more of the effect of an exchange rate change is offset by destination-specific adjustments of mark-ups over costs" (Goldberg and

Knetter, 1997: 1270). Regarding empirical evidence for developing countries, changes in the difference between the real exchange rate, expressed in relative unit labour costs, and the real exchange rate, expressed in relative consumer price, provide an approximate indirect measure of the impact of exchange rate changes on profits of developing-country exports. As shown in *TDR 2003* (fig. 5.3), the large currency depreciations in Mexico in 1994–1995 and in the Republic of Korea in 1997 restored profit margins earned by exporters of manufactures, which had been eroded in the years prior to the exchange rate crises.

In addition to strategic pricing behaviour, shifts in the marginal cost curves, due to changes in imported input costs stemming from the exchange rate change, may give rise to incomplete exchange rate pass-through. Campa and Goldberg (1999) show that for major developed countries, the importance of the exchange rate for marginal profitability and for investment responsiveness to exchange rates varies over time: positively in relation to sectoral reliance on export share, and negatively with respect to the share of imported inputs in production. Moreover, in low price-over-cost mark-up sectors, mark-ups are relatively unresponsive to exchange rate changes, whereas investment is strongly affected. By contrast, high mark-up industries absorb much of the exchange

"Pricing to market" allows exporters to maintain price competitiveness even after an exchange rate appreciation ...

... but trying to do so over a longer period of time risks compromising profit-related incentives for investment.

rate fluctuations in mark-ups and relatively little through real investment. Although systematic evidence for developing-country imports is not available, it is possible that foreign suppliers selling in large developing countries with sizeable import-competing sectors may engage in strategic pricing to market for selected important differentiated manufactured products. To the extent that this is the case, the price effect of exchange rate changes for domestic producers in import-competing industries and in export industries that have a large import content of differentiated products will be diminished.

Enterprises that cannot outweigh the adverse effect of exchange rate changes on competitiveness through productivity-enhancing investment or a squeeze in profit margins may need to resort to wage compression or labour shedding in order to stay in business. Assessments of the wage and employment response to real exchange rate movements often analyse net changes in wages per worker or employment across manufacturing industries. For example, *TDR 2003* (table 5.7) showed that wages were reduced in many African and Latin American countries in order to increase international competitiveness.

In brief, the impact of exchange rate changes on enterprise profits and investment varies across firms. Firms can limit the adverse effects of currency appreciations on their international cost competitiveness temporarily, if they are able to follow a pricing-to-market strategy and absorb at least part of the exchange rate change by a squeeze in profit margins. But trying to do so over a longer period of time risks compromising profit-related incentives for investment. On the other hand, firms may not be able to benefit from sharp real currency depreciations if the goods that they export have a large import content, so that the net effect of the currency depreciation on the firms' international cost competitiveness is very small. More importantly, recent experience shows that adverse impacts of sharp real currency depreciations can compromise the ability of firms to expand production capacity or even maintain production at pre-depreciation levels. Indeed, the easing of capital controls, combined with the movement away from detailed documentation requirements for trade financing transactions, have seriously compromised the availability of trade finance from

international sources in the aftermath of sharp currency depreciations. In addition, the tightening of domestic monetary conditions associated with the depreciation has made it difficult for domestic lenders to maintain their provision of short-term lending.

2. Sharp exchange rate changes and developing countries' export performance

At the macroeconomic level, maintaining a stable exchange rate at an appropriate level is crucial for successful exporting and structural change towards high-productivity sectors. Discussions on the impact of exchange rate changes on trade flows have frequently emphasized the effect of exchange rate volatility on trade, or the contribution of currency depreciations to the removal of temporary imbalances in a country's current account. Typically, the focus has been on the impact of exchange rate changes that are relatively small compared to the large gyrations in developing countries' real exchange rates that have frequently occurred since the early 1990s. This section briefly addresses the two issues discussed in the traditional debate, with its emphasis on relative small exchange rate movements. However, its main focus is on large changes in real exchange rates, often associated with sharp and abrupt changes in the direction of short-term private international capital flows. Such changes can cause substantial shifts in relative production costs and output prices across countries, and hence in relative competitive positions.

In its review of the impact of exchange rate volatility on trade, a recent study by the IMF (2004: 7) concludes: "On balance, it is not clear whether the major changes in the world economy over the past two decades have operated to reduce or increase the extent to which international trade is adversely affected by fluctuations in exchange rates." The study argues that, on the one hand, the liberalization of capital flows in the last 30 years, and the ensuing strong growth in the scale and variety of cross-border financial transactions have clearly increased the magnitude of exchange rate movements in some countries; the recent currency crises in emerging market economies being espe-

cially notable for their large exchange rate volatility. On the other hand, the proliferation of financial hedging instruments has made it possible for firms to reduce their vulnerability to the risks arising from volatile currency movements. Moreover, the fact that a growing proportion of international transactions is undertaken by TNCs, and exchange rate fluctuations may have mutually offsetting effects on their profitability, may have further reduced the impact of exchange rate volatility on world trade. However, it is likely that trade involving developed countries is relatively less sensitive to the adverse effects of exchange rate volatility, because most TNCs are based in developed countries, and hedging instruments are more readily available for the currencies of these countries. The results of their empirical analysis of trade and exchange rate volatility at the bilateral level led the authors of the IMF study to conclude that there is a generally small negative effect of exchange rate volatility on trade, but that this evidence is not robust across different model specifications.⁶

In its treatment of the impact of exchange rate changes on international trade flows, standard international trade theory emphasizes the mechanism that removes temporary imbalances in a country's current account. It shows that a real depreciation of the domestic currency reduces import demand and increases export demand for goods and services, thus restoring the current account balance if the sum of the relative price elasticities of export and import demand exceeds unity. Empirical estimates for price elasticities for international trade in manufactured goods by developed countries generally show that a real appreciation is likely to worsen the trade account. Conversely, a real depreciation is likely to improve it, except over short periods where the elasticities are typically too small to satisfy the elasticity condition, thereby causing the trade account to deteriorate immediately following a real depreciation.⁷

There has long been a debate in the literature on the ability of changes in the real exchange rate to improve the merchandise trade balance of developing countries in the medium and long run.⁸

Elasticity pessimists have argued that in developing countries, (i) the elasticity of import demand is low because most imports are production inputs, and the elasticity of substitution in production between imports and domestic value added is essentially zero; (ii) the elasticity of export supply is low because exports are concentrated in a few primary products with a very low domestic supply response; and (iii) the elasticity of export demand is low because world demand is inelastic, with respect to both income and prices, for the products exported by developing countries. Indeed, many developing-country exporters of primary commodities appear to be trapped in a vicious circle, where real exchange rate changes can play a fairly small role in increasing exports and reducing imports at the same time. The existing production structure in these countries can generate little diversification and export growth

in the absence of new investment in industry, which requires substantial imports and foreign exchange. Export growth is thus constrained by the inability to increase imports due to inadequate export earnings. This dilemma is accentuated when the loss of the purchasing power of exports is not compensated, and imports have to be reduced.⁹ In coun-

tries that face this dilemma, the persistent excessive reliance on exports of primary commodities to finance imports of goods and services has contributed to the accumulation of unsustainable debt burdens. However, while this is likely to limit, sometimes substantially, the positive response of the trade balance to real currency depreciations, empirical evidence shows that, in general, a real depreciation of the domestic currency improves the merchandise trade balance of developing countries (Ghei and Prichett, 1999).

The large size of recent real exchange rate changes brings an additional dimension to the traditional elasticity debate for at least two reasons. First, the external trade position of countries that are not directly subject to a sharp exchange rate change themselves can, nevertheless, be adversely affected. Second, the impact of sharp and abrupt exchange rate changes on the economy of the depreciating currency is more complex than the ad-

Sharp currency depreciations are often associated with economic recession and a sharp decline in the availability of trade finance.

justments resulting from small exchange rate fluctuations, because sharp currency depreciations are often associated with economic recession and, as discussed in some detail in the preceding section, with a sharp decline in the availability of trade finance.

Looking first at the effects of crisis on countries other than the crisis-hit country, the literature shows that financial crises can be transmitted through trade linkages from a directly affected country to other countries that export similar goods, even if those countries have relatively good fundamentals. The way in which changes in relative prices and/or quantities of goods traded by a crisis-hit country can have spillover effects in other economies operates through a number of distinct channels that can counteract each other (see, for example, van Wincoop and Yi, 2000).

For example, sharp exchange rate changes have a significant impact on relative output prices. These, in turn, affect the relative competitiveness of countries' exports, even if a country does not directly compete with exports from the crisis-affected country in any specific market. This is because the depreciation reduces the relative price of a country's exports, and therefore shifts demand away from countries that produce similar goods. If exports from the crisis-affected country constitute a large enough share of global markets in a given industry, prices in that industry will fall worldwide (for a numerical example, see Pesenti and Tille, 2000: 9). One example of this is the electronics sector in the aftermath of the Asian crisis. Barth and Dinmore (1999) show, for instance, that part of the reason for the price slump in electronic components was the glut in supply created by the troubled Asian economies in their attempt to pursue export-led recoveries from the recession.

A diametrically opposite effect occurs when a country not affected by crisis imports produc-

tion inputs from a crisis-affected country. The decline in prices of these imported inputs, resulting from the crisis, leads to a change in relative inputs prices, so that the effect is equivalent to that of a positive productivity shock.

Both external demand and the competitiveness of domestic exporters have a significant impact on developing countries' export performance ...

Finally, a crisis-affected country may experience a sharp contraction in economic growth and a reduction in aggregate demand, followed by a reduction in import demand. If imports by the crisis-affected country constitute a large enough share of global markets in a given industry, prices in that industry will fall worldwide. For example, the Asian crisis was followed by a widespread and pronounced fall in commodity prices, which was reflected in a decline in the price index for non-oil commodities by about 30 per cent (*TDR 2000*: 33). This price slump created balance-of-payments and fiscal difficulties for a number of commodity-exporting developed and developing countries.

There is an ongoing debate as to whether these trade linkages have been large and/or significant determinants of how different countries were affected by recent financial crises. The debate is unresolved partly because of the difficulty in disentangling trade and financial linkages. In spite of variations in currency crisis events, approaches and estimation techniques, most empirical studies have, nevertheless, found support for the importance of trade in the international transmission of crises.¹⁰

... but the relative importance of these two factors differs, depending on the composition of exports and different periods of time.

One recent study on the Asian crisis (Duttagupta and Spilimbergo, 2004) emphasizes competitive depreciations as an important form of contagion through trade linkages. This means that countries whose exporters compete directly with those in the crisis-affected country face pressure to depreciate their currencies as well, in order to allow their firms to reduce export prices and avoid a loss in international competitiveness. On the other hand, this also means that exporters in the crisis-affected

country do not experience a rise in demand for their products, as would have been the case had the competitive depreciations not enabled their competitors to cut prices.

Turning to the impact on trade performance of the country with the strongly depreciating currency, the large size of recent real exchange rate changes complicates empirical analysis. This concerns, for example, statistical measurement, given that comprehensive data on the price and volume components of export values are not available. One study shows that changes in export prices, rather than changes in export volumes, were mainly to blame for the poor performance of dollar-denominated export revenues in Hong Kong (China), Indonesia, Malaysia, the Republic of Korea, Singapore, Taiwan Province of China and Thailand in the aftermath of the East Asian crisis in 1997–1998. The export prices of these six economies fell by 4.8 per cent in 1997 and by a further 9.1 per cent in 1998. Thus, while aggregate export revenue for these six economies was nominally up by 6.1 per cent in 1997 and fell by 3.6 per cent in 1998, export volumes rose by 8.8 and 0.7 per cent respectively in these two years (Barth and Dinmore, 1999).

The UNCTAD secretariat conducted some econometric estimations with the basic objective of assessing the impact of changes in international cost competitiveness on developing countries' merchandise trade performance for the period 1970–2002. Annex 2 to this chapter explains the set-up of these estimations, where international cost competitiveness is measured by the exporting country's real effective exchange rate, and merchandise trade performance is captured by four variables: (i) the merchandise trade balance; (ii) total merchandise exports as a percentage of nominal income; (iii) total merchandise imports as a percentage of nominal income; and (iv) the country's market share in total world manufactured exports. Due to its strategic importance for policy-making and the development of external indebtedness, the current account balance was included in the estimations as a fifth dependent vari-

able. Given that cross-country variations in the rate of real income growth are also likely to influence countries' trade flows, the estimations also consider the impact of changes in world income and in the exporting country's income. Following the discussion above, the anticipated impact of real exchange rate changes on the trade performance variables is that a depreciation increases exports and export market shares, while it reduces imports; these effects combined imply that a depreciation is expected to improve the merchandise trade balance, as well as the current account balance. At the same time, accelerated domestic (world) income growth is expected to boost imports (exports).

It is not immediately clear whether the econometric estimation can be expected to reveal the anticipated inverse relationship between changes in competitiveness, as measured by the real effective exchange rate, and changes in a country's share in world exports of manufactures. Firstly, the market share of a country whose currency depreciates declines due to a statistical effect. For example, if a country's currency depreciates by 10 per cent vis-à-vis the dollar, its market share, measured in dollar terms, also drops by 10 per cent. However, a statistical method that would allow taking account of this effect is not available. Secondly, cross-country differences in the rise of export market shares following a currency depreciation are influenced by differences in the growth rate of aggregate demand in the exporting country's trading partners. Thirdly, the entry of countries into the world trading system automatically reduces the market shares of the other countries, as occurred when China and the countries of the former Council For Mutual Economic Assistance (CMEA) began to participate more actively in world trade.

Fourthly, Kaldor found that between 1956 and 1976 the United States and the United Kingdom suffered a decline in their share of manufactured exports to major developed-market economies, while they became more competitive – as measured by changes in relative unit labour costs – and Germany, Italy and Japan saw a rise in their market

Major exchange rate depreciations neither give a sizeable additional boost to export performance nor result in proportionally larger improvements in the trade balance.

shares, while they became less competitive on this measure. Based on these findings (frequently referred to as the ‘Kaldor paradox’), Kaldor (1978: 104) argued that “the changes in exchange rates and in ‘competitiveness’ as conventionally measured were not the cause, but the consequence of differing *trends* in the market shares of different industrial countries, and the ‘trends’ themselves must then be due to factors not susceptible to measurement.”

However, this argumentation does not take account of the level from which changes have occurred. At the beginning of the 1970s, the currencies of both Germany and Japan were undervalued by more than 10 per cent (Williamson, 1983), so that currency appreciation had substantial leeway to reduce these countries’ advantage in exchange-rate-based competitiveness before eliminating or even reversing it. Thus part of the explanation of this “paradox” is likely to be found in the fact that the observed currency movements implied a correction of previously accumulated misalignments, rather than movements away from an equilibrium value. Moreover, Kreinin (1977) estimated for the early 1970s that the exchange rate pass-through to United States import prices was only 50 per cent, and to German and Japanese import prices about 60–70 per cent. This means that exporting firms transmitted exchange rate changes only partially to sales prices measured in foreign currency, and absorbed the other part through changes in their profit margins.¹¹

The relationship between the real exchange rate and market shares in world manufactured exports in developing countries diverges widely, as shown in figure 4.1 for six major developing-country exporters of manufactures. In East Asia, relatively stable real effective exchange rates accompanied the dramatic rise of the share in world manufactured exports of the Republic of Korea and Taiwan Province of China between the early 1970s and the late 1980s. But most East Asian economies, in order to maintain their cost competitiveness, have successfully stabilized their real exchange rates – although sometimes at an undervalued level – through a consensus based on nominal wage increases, in line with productivity growth, capital controls and interventions in the currency market. Following the Asian crisis in 1997–1998, the experience of the Republic of

Korea and Taiwan Province of China has been characterized by a combination of a trend towards real currency depreciation and an increase in market share. For Brazil, India and Turkey, periods of rapidly increasing market shares in world manufactured exports have broadly coincided with periods of real currency depreciations. Mexico is the only country in the figure where, during the second half of the 1990s, a rise in market shares was accompanied by real currency appreciation. However, as discussed in previous *TDRs*, given that Mexico’s exports of manufactures increased rapidly following the entry into force of the North American Free Trade Agreement (NAFTA) in 1994, and since they have a significant import content and comparatively little domestic value added, it is no surprise that real currency appreciation had no significant adverse impact on the evolution of market shares. Taken together, the figure provides broad statistical evidence to support the argument that, over the long term, increases in market shares in world manufactured exports are associated with periods of real currency depreciations.

This contrasts with the results of the econometric estimation in table 4.1, which shows that, in general, over the period 1971–2002 as a whole, exchange rate changes had no statistically significant impact on changes in the share of world manufactured exports for the selected 28 developing economies and Central and Eastern European countries (CEECs). Looking at the results for different country groups, this finding also holds for the group of Asian and Latin American economies included in the sample. Similar to the above discussion of the Kaldor paradox, a possible explanation for this finding is that the analysis focuses on changes in the real effective exchange rate, but does not take account of the level from which these changes occurred. As already mentioned, the growth of exports from East Asian economies was associated with a strategy of maintaining real exchange rate stability, sometimes at an undervalued level. This implies that these countries’ market shares were able to increase even with a slight real currency appreciation. In contrast, in much of Latin America, periods of sometimes prolonged exchange rate overvaluation, followed by real currency depreciations, may not have led to increasing market shares for their exports.¹²

Figure 4.1

EXCHANGE RATES AND SHARE IN WORLD EXPORTS OF MANUFACTURES, SELECTED DEVELOPING ECONOMIES, 1970–2002



Source: UNCTAD secretariat calculations, based on JP Morgan (2003) for exchange rate data; and the UNCTAD database for trade data.

Table 4.1

**IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON
EXTERNAL PERFORMANCE: ESTIMATION RESULTS, 1971–2002^a**

	<i>Share in world manufactured exports</i>	<i>Merchandise trade balance</i>	<i>Current account balance</i>	<i>Income share of exports</i>	<i>Income share of imports</i>
Total sample					
Real effective exchange rate	0.01	-0.35*	-0.23*	-0.59*	-0.17**
Real domestic income	0.94*	-1.02*	-0.90*	-0.32**	0.76*
Real world income	1.81*	2.67*	1.25*	2.56*	-0.42
R-square	0.25	0.21	0.26	0.27	0.09
Total panel observations	679	677	585	679	684
Asia					
Real effective exchange rate	-0.02	-0.28*	-0.18*	-0.47*	-0.14
Real domestic income	1.51*	-0.57*	-0.66*	0.05	0.61*
Real world income	1.82*	2.55*	0.74**	2.50*	-0.03
R-square	0.47	0.24	0.38	0.28	0.08
Total panel observations	330	328	247	330	328
Latin America					
Real effective exchange rate	-0.05	-0.46*	-0.33*	-0.82*	-0.28**
Real domestic income	-0.20	-2.73*	-1.83*	-1.20*	1.41*
Real world income	3.19*	5.28*	3.81*	2.89*	-2.29*
R-square	0.06	0.37	0.39	0.37	0.13
Total panel observations	192	192	167	192	192
Central and Eastern Europe					
Real effective exchange rate	0.30**	-0.18	-0.24	-0.42*	-0.14
Real domestic income	0.39	-1.33	-1.04***	-0.76	-0.11
Real world income	-4.84*	-0.96	-1.03	2.89**	3.44*
R-square	0.51	0.27	0.27	0.36	0.30
Total panel observations	46	46	46	46	46

Source: UNCTAD secretariat calculations, based on JP Morgan (2003) for exchange rate data; IMF, *International Financial Statistics* database for current account data; and the UNCTAD database for trade and income data.

a For Central and Eastern Europe, estimations refer to the period 1995–2002.

* Denotes significant at the 1 per cent level.

** Denotes significant at the 5 per cent level.

*** Denotes significant at the 10 per cent level.

The estimation results in table 4.1 also show that, as anticipated, depreciations led to a statistically significant improvement in the merchandise trade balance, as well as in the current account balance. However, contrary to expectations, the results show that depreciations led to a rise – in most cases statistically significant – in the income

shares of both imports and exports. But this result for the entire sample period masks a noteworthy evolution of the impact of exchange rate changes on the income shares of imports and exports (table 4.2). Looking only at the 1970s, the results show that depreciations led to the anticipated decline in the income share of imports and to a rise

in the income share of exports, although the coefficient on imports is statistically not significant. The coefficient on the income share of exports rises in size and maintains both its sign and statistical significance for the 1980s and for the period 1990–2002. By contrast, the coefficient on the income share of imports changes its sign, and for the period 1990–2002 the results show that depreciations led to a statistically significant rise in the income share of imports. It is likely that this evolution in the impact of exchange rate changes on imports mirrors the increased import content of developing-country exports, which has occurred with the rising importance of developing-country participation in international production networks since the mid-1980s. High import intensity of exports makes imports and exports move in the same direction, independently of the direction of exchange rate changes.

Concerning the impact of changes in income on trade performance, the results in table 4.1, for the entire sample and for the group of Latin American countries, show that, as expected, rising growth in domestic demand led to growing income shares of imports and declining income shares of exports. For the group of Asian economies, higher domestic (world) demand had no statistically significant impact on the income share of exports (imports). The increasing importance of changes in regional income for the trade performance of these countries might explain this finding. The results also show that an increase in world income leads to a sharply rising income share of exports in both regions and to a strong improvement in the merchandise trade balance.

Possible lagged reactions of trade performance can reverse the impact that occurs immediately after exchange rate changes (i.e. J-curve effects may arise). Imposing time lags on the exchange rate variable to detect such lagged reactions reveals that statistically significant effects on exports occur in the same period as the exchange rate change as well as in the subsequent period, while the effects on imports are statistically significant up to three years after the exchange rate change. The combined effect of these cumulative changes implies that a 10-per-cent depreciation leads to an improvement in the trade balance by more than 0.6 percentage points in the year following the depreciation, and that this improvement remains

Table 4.2

IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON INCOME SHARES OF IMPORTS AND EXPORTS: ESTIMATION RESULTS FOR SELECTED PERIODS

	<i>Income share of exports</i>	<i>Income share of imports</i>
1971–1980		
Real effective exchange rate	-0.28*	0.10
Real domestic income	0.09`	1.07*
Real world income	1.98*	-2.62*
R-square	0.17	0.13
Total panel observations	192	192
1980–1990		
Real effective exchange rate	-0.56*	-0.05
Real domestic income	-0.06	0.94*
Real world income	1.70*	1.31*
R-square	0.23	0.23
Total panel observations	208	213
1990–2002		
Real effective exchange rate	-0.97*	-0.46*
Real domestic income	-0.43*	0.98*
Real world income	3.72*	1.31*
R-square	0.72	0.28
Total panel observations	272	272

Source: See table 4.1.

Note: All results refer to country samples excluding CEECs.

* Denotes significant at the 1 per cent level.

** Denotes significant at the 5 per cent level.

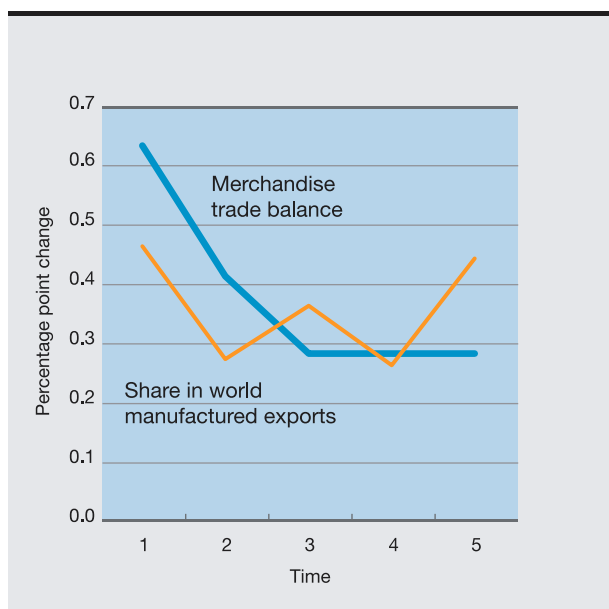
*** Denotes significant at the 10 per cent level.

at about 0.3 percentage points in the medium term, as shown in figure 4.2. The figure also shows that a 10-per-cent depreciation leads to a cumulative increase in the market share in world manufactured exports by about 0.4 percentage points during the five-year period following the depreciation.

A country's export composition is likely to influence the relative strength of the impact on trade performance of changes in the real exchange rate on the one hand, and of external demand on the other. External demand will tend to be rela-

Figure 4.2

CURRENCY DEPRECIATIONS AND TRADE PERFORMANCE: TIME PATH OF ADJUSTMENT



Source: See table 4.1.

Note: The graph shows the cumulative effect of a 10-percent currency depreciation occurring in time $t = 0$ on trade performance over the subsequent five years.

tively more important for countries that rely for most of their export earnings on comparatively homogeneous primary products. Changes in supply and demand conditions on world markets determine price changes on the world market for homogeneous products. As a result, rather than boost its export performance, a country's currency depreciations would diminish its export earnings, measured in domestic currency, and hence worsen its barter terms of trade. By contrast, relative changes in domestic production costs of countries' manufacturing exports influence price changes on world markets for manufactures. Hence, price competitiveness (as measured by the real exchange rate) will be a relatively more important determinant of the trade performance of major exporters of manufactures.

Dividing the country sample into countries that are major exporters of manufactures and other countries¹³ leads to no change in the general pat-

tern of the results obtained for the entire sample discussed above. However, the results presented in table 4.3 reveal that, with respect to the relative impact of changes in the real effective exchange rate and in world income on changes in the merchandise trade balance, the former is indeed more important for major exporters of manufactures, while the latter is more important for the other countries. A further noteworthy difference in the trade performance of these two groups of countries relates to the lag structure of the impact of changes in the real effective exchange rate on the countries' share of world export markets. Changes in the real effective exchange rate have a statistically significant impact on changes in the share of major exporters of manufactures in both total world exports and world exports of manufactures over several years, with a 10-percent depreciation leading to a cumulative increase in world market shares by about 0.2 percentage points over the subsequent five years (fig. 4.3). By contrast, none of the coefficients on the lagged exchange

Table 4.3

IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON THE MERCHANDISE TRADE BALANCE: ESTIMATION RESULTS FOR SELECTED COUNTRY GROUPS, 1971–2002

	<i>Merchandise trade balance</i>
Major exporters of manufactures	
Real effective exchange rate	-0.43*
Real domestic income	-0.69*
Real world income	2.63*
Other countries	
Real effective exchange rate	-0.24***
Real domestic income	-1.89*
Real world income	3.92*
R-square	0.24
Total panel observations	631

Source: See table 4.1.

Note: See table 4.2.

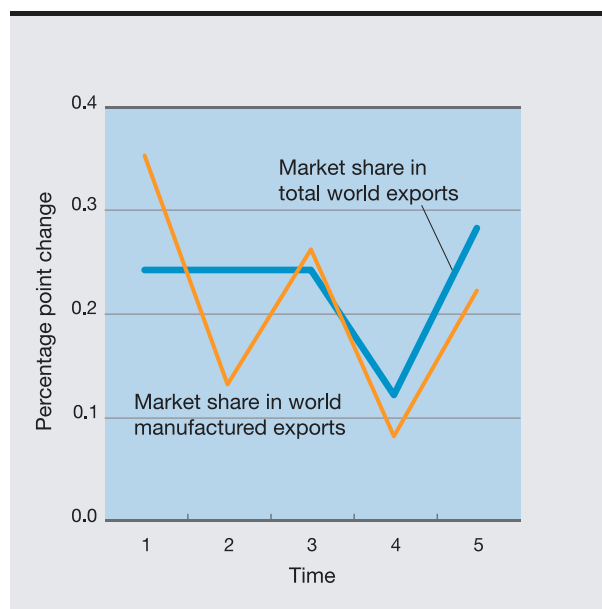
rate variable is statistically significant for the share of other countries in total world exports.

Concentrating on the income share of exports, the results in table 4.2 discussed above show that real currency depreciation boosted exports, but that export growth was particularly sensitive to an increase in world income. In this sense, while both factors had a significant impact, external demand appears to have been a relative more important factor influencing merchandise trade performance than the competitiveness of domestic producers. On the other hand, comparing the size of the coefficients for the real effective exchange rate and world income growth for the 1970s and for the period 1990–2002, reveals that the relative strength of the effects of improved domestic supply capacity increased and that of greater external demand decreased. This is true for all the developing countries combined, as well as for the group of Latin American and Asian countries and economies taken separately. By contrast, splitting the country sample into the group of major exporters of manufactures and other countries reveals that this pattern applies to the former group, while for the export performance of developing countries that rely on primary commodities, the impact of external demand became increasingly pronounced (table 4.4). This shows that both external demand and the competitiveness of domestic exporters have a significant impact on developing countries' export performance, but their relative importance differs, depending on the composition of exports and different periods of time.

Separating changes in the real exchange rate based on changes in fundamental factors (such as relative productivity and wage developments) from those based on other factors would ideally rely on an assessment of changes in the equilibrium exchange rate and deviations from the equilibrium rate. However, there is no agreement as to whether, or how, an equilibrium exchange rate can be determined theoretically, and the data required to test existing concepts empirically are often not available for developing countries or incomplete. A second way of gaining a general insight into when exchange rate changes are unrelated to changes in fundamentals that do not depend on the credibility of any particular estimates of an equilibrium exchange can be based on the assumption that changes in those funda-

Figure 4.3

CURRENCY DEPRECIATIONS AND EXPORT MARKET SHARES: TIME PATH OF ADJUSTMENT FOR MAJOR EXPORTERS OF MANUFACTURES



Source: See table 4.1.

Note: See figure 4.2.

mentals are usually not very large. Hence, it can be assumed that changes in the real exchange rate that exceed a certain threshold level are unlikely to reflect changes in fundamentals; rather they are likely to reflect substantial changes in the nominal exchange rate, partly due to changes in the demand for currencies as capital assets.

Consequently, in order to separate major from minor changes in the real effective exchange rate, the following analysis defines “major changes” as any change in a three-month period during 1970–2002, when a country’s real effective exchange rate depreciated or appreciated by 15 per cent or more.¹⁴ The resulting list of major changes in real effective exchange rates (table 4.5) includes the well-known recent currency crises, such as the series of devaluations in East Asia in 1997–1998; the devaluations in Mexico, the Russian Federation, South Africa and Brazil in the late 1990s; and the Argentinean devaluation in early 2002 following the collapse of its currency board. It also includes a number of strong appreciations, some

Table 4.4

**IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON INCOME SHARE OF EXPORTS:
ESTIMATION RESULTS FOR SELECTED COUNTRY GROUPS AND PERIODS**

	<i>Country groups by geographical region</i>		<i>Country groups by export structure</i>	
	<i>Asia</i>	<i>Latin America</i>	<i>Major exporters of manufactures</i>	<i>Other countries</i>
1971–1980				
Real effective exchange rate	-0.11	-0.25**	-0.19	-0.32*
Real domestic income	0.37	-0.50	0.29	-0.39
Real world income	2.03**	2.58*	1.93*	2.02**
R-square	0.20	0.17	0.19	0.16
Total panel observations	100	60	110	82
1980–1990				
Real effective exchange rate	-0.31*	-0.95*	-0.48*	-0.75*
Real domestic income	0.48**	-1.53*	0.30	-0.89**
Real world income	1.97*	4.12*	1.38**	2.45***
R-square	0.28	0.49	0.24	0.31
Total panel observations	110	66	121	87
1990–2002				
Real effective exchange rate	-0.91*	-1.18*	-0.83*	-1.06*
Real domestic income	-0.27*	-0.94*	-0.55*	-0.29*
Real world income	3.28*	4.82*	3.49*	4.35*
R-square	0.77	0.69	0.64	0.73
Total panel observations	140	78	153	119

Source: See table 4.1.

Note: See table 4.2.

of which reflect a sharp rebound of the exchange rate following a currency crisis (as in Indonesia in 1998). It is interesting to note that there were more than twice as many major depreciations than there were appreciations. Moreover, the fact that almost one third of the major depreciations during the 33-year period occurred after the Mexican crisis at the beginning of 1995 reflects the increasing frequency of exchange rate crises or their contagion effects. While each of these episodes had its own special characteristics, two common features are: (i) that the crises were preceded by periods of sharply increasing capital inflows attracted by an interest rate differential (i.e. a relatively high level of domestic interest rates, of-

ten in the context of tight monetary policy designed to attain or maintain price stability), and associated with a slow but continuous appreciation of the real exchange rates, and (ii) that they were triggered by a sharp swing in expectations of international investors – often associated with rising international rates and a deterioration of domestic macroeconomic conditions resulting from the effects of the capital inflows, rather than with shifts in domestic policies – which led to large-scale selling of the country's currency (*TDR 2003*, chapter VI).

The varying impact on trade performance between major and other real currency deprecia-

Table 4.5

**MAJOR CURRENCY DEPRECIATION AND APPRECIATION EVENTS,
SELECTED ECONOMIES, 1970–2002**

	<i>Major depreciations</i>					<i>Major appreciations</i>		
Argentina	1975 (2)	1977 (1)	1981 (2)	1989 (2)	2002 (1)	1976 (1)	1988 (3)	1990 (2)
Brazil	1971 (4)	1983 (1)	1999 (1)	2002 (3)		1990 (1)		
Chile	1973 (3)					1972 (2)		
China	1986 (3)	1988 (2)						
India	1991 (3)							
Indonesia	1978 (4)	1983 (2)	1986 (4)	1997 (4)		1971 (1)	1998 (4)	2001 (3)
Mexico	1976 (4)	1982 (3)	1995 (1)					
Morocco	1974 (2)							
Pakistan	1972 (2)							
Republic of Korea	1998 (1)							
Russian Federation	1998 (3)					1995 (2)		
Saudi Arabia						1974 (4)	1976 (3)	
South Africa	1984 (3)	1998 (3)	2001 (4)			1986 (1)		
Taiwan Prov. of China						1974 (1)		
Thailand	1997 (3)					1974 (1)		
Turkey	1994 (1)					2002 (1)		
Venezuela	1984 (1)	1987 (1)	1989 (2)	1996 (2)	2002 (3)			

Source: UNCTAD secretariat calculations, based on exchange rate data from JP Morgan (2003).

Note: Major depreciation or appreciation events here are defined as a change in the real effective exchange rate of 15 per cent or greater in any three-month period between 1970 and 2002; the three quarters following such an event are excluded, so that there can be at most one event within any four-quarter period. The numbers in brackets indicate the quarter in which the event occurred.

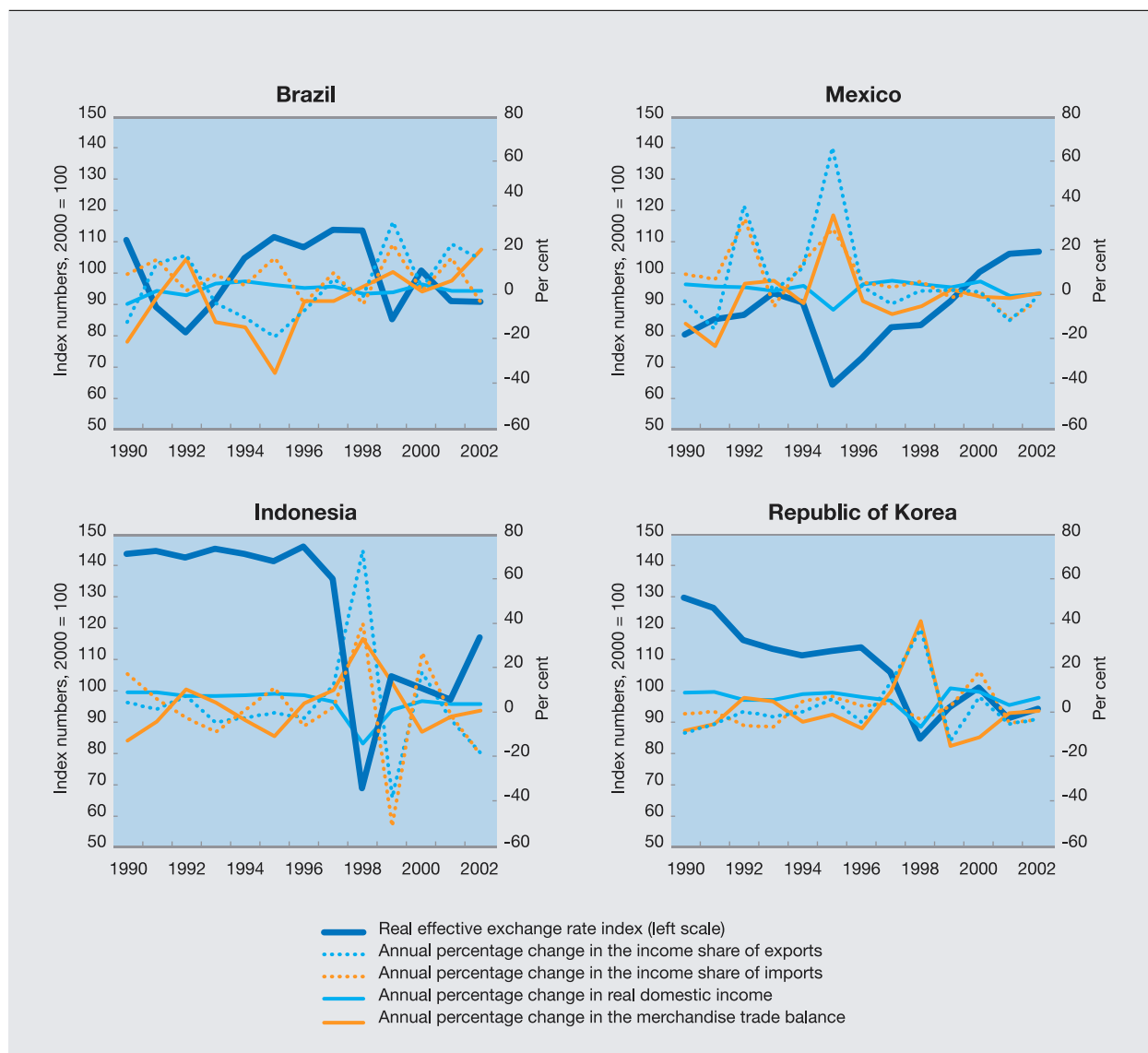
tions is illustrated in figure 4.4, which shows the experience of four countries recently affected by a currency crisis: Brazil (1999), Indonesia (1997), Mexico (1995) and the Republic of Korea (1998). While the underlying mechanisms are undoubtedly complex, partly due to the varying divergence of the exchange rates from their equilibrium values prior to the currency crisis, some general observations can be made. Looking only at the relationship between changes in the real exchange rate and in the merchandise trade balance (represented by the ratio of merchandise exports to imports), Mexico and the Republic of Korea experienced a sharp real depreciation and a strong improvement in the trade balance during the period 1990–2002. The improvement in the trade balance of Brazil and Indonesia associated with

the sharp currency depreciation, is also large, but smaller than in Mexico and the Republic of Korea. This may be due to the fact that the share of manufactures in total merchandise exports of the latter two countries was considerably larger than that in Brazil and Indonesia. Overall, this could lead to the conclusion that, regarding their impact on trade performance, sharp real depreciations are simply extreme examples of real depreciations of a more ordinary size.

However, looking at the evidence more closely reveals two specific features of sharp real currency depreciations. One is that they were accompanied by a sharp decline in real domestic income in all four countries shown in the figure, except Brazil. Moreover, the income share of imports increased

Figure 4.4

TRENDS IN THE REAL EFFECTIVE EXCHANGE RATE, INCOME AND TRADE PERFORMANCE, SELECTED DEVELOPING COUNTRIES, 1990–2002



Source: See table 4.1.

much less than the income share of exports. Thus, contrary to more ordinary real currency depreciations, sharp real currency depreciations are often accompanied by a decline in domestic economic activity and imports. Combined with the sharp decline in the availability of trade finance, which often follows sharp currency depreciations, as discussed above, this is likely to hamper the supply response of the country with the depreciating currency.

The results of the estimations relating to the impact on trade performance of these major exchange rate changes as compared to others, are shown in table 4.6. They show that major currency depreciations boosted countries' export performance only slightly more than more normal depreciations. Most importantly, contrary to depreciations of relatively small size, major depreciations did not lead to a statistically significant improvement in the trade balance. By contrast,

Table 4.6

**IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON EXTERNAL PERFORMANCE:
ESTIMATION RESULTS FOR DIFFERENT SIZES OF EXCHANGE RATE CHANGE, 1971–2002**

	<i>Merchandise trade balance</i>	<i>Current account balance</i>	<i>Income share of exports</i>	<i>Income share of imports</i>	<i>Share in world manufactured exports</i>
Major appreciations and depreciations					
Real effective exchange rate	-0.30	-0.08	-0.56*	-0.26	-0.18
Real domestic income	-2.27*	-1.79*	-1.77*	0.65	0.51
Real world income	3.91*	2.47**	5.75*	1.15	0.38
Other appreciations and depreciations					
Real effective exchange rate	-0.31*	-0.23*	-0.49*	-0.11	0.07***
Real domestic income	-0.88*	-0.83*	-0.05	0.86*	1.00*
Real world income	2.57*	1.09*	2.34*	-0.58**	1.80*
R-square	0.22	0.24	0.31	0.10	0.27
Total panel observations	677	585	679	684	679
Major appreciations					
Real effective exchange rate	-0.13	0.13	-0.44	-0.29	-0.27
Real domestic income	-1.54	-1.26	-0.72	0.86	1.01
Real world income	2.57	2.41	5.51**	2.69	1.22
Major depreciations					
Real effective exchange rate	-0.45	-0.41*	-0.86*	-0.46	-0.19
Real domestic income	-2.85*	-2.13*	-2.24*	0.78	0.41
Real world income	3.70**	0.57	4.23**	-0.37	0.16
Other appreciations and depreciations					
Real effective exchange rate	-0.31*	-0.22*	-0.49*	-0.10	0.07
Real domestic income	-0.89*	-0.84*	-0.06	0.86*	1.01*
Real world income	2.62*	1.16*	2.41*	-0.56***	1.79*
R-square	0.23	0.26	0.31	0.10	0.27
Total panel observations	677	585	679	684	679

Source: See table 4.1

Note: * Denotes significant at the 1 per cent level.
** Denotes significant at the 5 per cent level.
*** Denotes significant at the 10 per cent level.

changes in domestic income and world income had a sizeable and strongly significant impact on the ability of exporters to take advantage of increased international price competitiveness. Indeed, the results show that following major currency movements, a rise in the income share of exports was

strongly and adversely affected by changes in domestic demand, while changes in domestic demand had no statistically significant impact on the income share of imports.¹⁵ Thus currency depreciations and changes in domestic income and world income had a markedly different short-term

Table 4.7

IMPACT OF CHANGES IN EXCHANGE RATES AND INCOME ON THE MERCHANDISE TRADE BALANCE: TIME PATH OF ADJUSTMENT, 1971–2002	
	<i>Merchandise trade balance</i>
Major appreciations and depreciations	
Real effective exchange rate	-0.10
One year lagged	-0.51
Two years lagged	0.32
Three years lagged	0.23
Four years lagged	0.20
Five years lagged	-0.89**
Real domestic income	-2.65*
Real world income	5.20*
Other appreciations and depreciations	
Real effective exchange rate	-0.26*
One year lagged	-0.26*
Two years lagged	0.22*
Three years lagged	0.13**
Four years lagged	0.11**
Five years lagged	-0.01
Real domestic income	-0.79*
Real world income	1.19*
R-square	0.31
Total panel observations	547

Source: See table 4.1

Note: * Denotes significant at the 1 per cent level.
 ** Denotes significant at the 5 per cent level.
 *** Denotes significant at the 10 per cent level.

impact on countries' trade performance when they were associated with major exchange rate changes rather than with comparatively smaller ones.

This finding is supported by the results in table 4.7, which show that comparatively small exchange rate changes improved the trade balance in the short run, while there was no similar statistically significant effect of major exchange rate changes. The results in table 4.6 also show that, contrary to their impact on the trade balance, major currency depreciations led to a statistically significant improvement of the current account balance. This is likely to be related to the decline in the commissions and fees such as for letters of credit or lines of credit that accompanied the sharp decline in the access of firms to trade finance and working capital provided by foreign banks in the aftermath of financial crises. It may also reflect changes in the provision of services with a relatively high elasticity with respect to changes in exchange rates and income.

The finding that, compared to depreciations of a more normal size, major exchange rate depreciations neither give a sizeable additional boost to export performance nor result in proportionally larger improvements in the trade balance is likely to reflect also the impact of at least one other factor discussed earlier. The observed worsening of firms' access to trade finance from both international and domestic sources in the aftermath of major currency depreciations makes it difficult for those firms to expand or even merely maintain activity levels. This seriously inhibits their supply response to benefit from lower dollar-denominated export prices.

C. Policy adjustment with open capital accounts

For policy makers in developing countries, the fact that exchange rate changes can influence the overall competitiveness of a country and have the potential to directly improve the overall trade performance of the majority of their firms and the balance of payments is a promising prospect. On the other hand, the use of the exchange rate as a powerful tool of economic policy is often strictly limited by the influence that the global capital market and the policy of other countries exert on that rate. The exchange rate of any country is, by definition, a multilateral phenomenon, and any rate change has multilateral repercussions.

In the last three decades, developing and emerging-market economies in all the major regions have had to struggle with financial crises or their contagion effects once they have tried to manage the exchange rate unilaterally or even opted for free floating. Nevertheless, in the Bretton Woods era, as well as in the period of floating or managed floating thereafter, some patterns of successful adjustment to the vagaries of the international capital market emerged, which have been increasingly adopted by developing countries' economic and financial policies. Since the Second World War, some experiences of successful catching up – such as by Western Europe, Japan and the NIEs – suggest that, among other factors, long-lasting currency undervaluation can be extremely helpful to fully reap the benefits of open markets. Today, as multilateral arrangements do not exist on a global scale, a strategy to avoid overvaluation by any means has become the preferred tool of many governments and central banks.

This is in stark contrast to the experience of the 1990s in Latin America. During that decade many Latin American countries maintained hard or soft currency pegs with some overvaluation during the 1990s, and used the exchange rate as a nominal anchor to achieve rapid disinflation. This led to an impressive improvement in their monetary stability (Fischer, 2001: 9; Mussa et al., 2000) but also to currency appreciations that impaired the competitiveness of exporters in these countries. Today, with inflation rates being relatively low and stable due to favourable domestic conditions, adopting a strategy designed to avoid currency overvaluation has become feasible for a much larger number of developing countries. Indeed, many developing countries (such as China, Brazil and South Africa) have recently sought to avoid a revaluation of their currencies through direct central bank intervention, with the result that they have accumulated substantial amounts of foreign-exchange reserves.

It is clear that for these countries, avoiding currency overvaluation is not only a means to preserve or improve macroeconomic competitiveness, but also an insurance against the risk of future financial crises. The accumulation of current account deficits, and frequent financial crises, with overshooting currency depreciations, proved very costly in the past. Surges in inflation, huge losses of real income, and rising debt burdens have been a common feature of all recent financial crises.

However, a strategy of avoiding currency overvaluation cannot easily be implemented if the

capital account is open. If inflation rates in developing countries exceed those in the developed world, or if there are expectations of an imminent currency appreciation, monetary policy will often face a dilemma in trying to keep the exchange rate stable and yet at a level that preserves the international cost competitiveness of the country's exporters.

1. *The dilemma posed by capital account openness*

Even a slightly diverging inflation trend between two open economies is sufficient for highly volatile short-term international capital flows to force the central bank of the country with high inflation to give up its undervaluation strategy or to face the severe fiscal costs that can be associated with this strategy.¹⁶ Differences in inflation rates are usually reflected in differences in nominal interest rates, with the high-inflation country having higher interest rates than the low-inflation country, even if both countries have similar growth trends and a similar monetary policy stance (e.g. if they try to apply a Taylor rule¹⁷). The reason for this is that nominal interest rates have to be higher in the high-inflation country if the central bank is to bring the domestic real interest rate in line with the given real growth rate and degree of capacity utilization.

However, short-term capital flows are not driven exclusively by interest rate differentials. Speculators may attack the currencies of countries that follow an undervaluation policy, because they expect a revaluation to occur sooner or later. This means that, contrary to textbook scenarios, in the real world, international investors do not form short-term exchange rate expectations on the basis of the purchasing power parity (PPP) rule.

Since the PPP rule is relevant only over the long term, policy-makers in financially open developing countries need to be aware that international investors in short-term deposits base their

decisions on the expected nominal return rather than the expected real return on investments. This is because portfolio investors do not intend to buy goods in the country in which they invest, but simply invest money for a day, a week or three months. If, during that period of time, the inflation divergence between the high-inflation and the low-inflation country does not trigger the generally expected depreciation of the high-inflation country's currency, portfolio investment will be more attracted to the high-inflation than to the low-inflation country. As discussed in *TDRs 1998* and *2001*, most of the financial crises in the post-Bretton Woods era have been characterized by unsustainable nominal interest rate differentials. The differential in nominal interest rates attracts portfolio investment in the currency of the high-inflation country. This, in turn, improves the short-term attractiveness of the high-inflation country's currency, because an appreciation would increase the expected return from such an investment. On the other hand, if governments try, from the outset, to limit the extent of an appreciation of the domestic currency by buying foreign currencies, this will usually add to the confidence of international investors as the high-inflation country's international reserves increase.

Thus, independently of whether high nominal interest rates or the expectation of a revaluation attract short-term capital inflows, the currency of the high-inflation country will tend to appreciate in the short-term.¹⁸ This undermines the fundamental external equilibrium between the high-inflation and the low-inflation country and risks increasing the volatility of the nominal and real exchange rates. The presence of an interest-rate differential, which determines the movement of the real exchange rate in the short term, does not preclude the exchange rate from eventually returning to PPP. In the medium term, the clearly visible deterioration of the international competitive position of the high-inflation country will reverse expectations of international investors: they will lose "confidence" in the high-inflation country's currency, thus making a correction of the overvaluation unavoidable.

International investors in short-term deposits base their decisions on the expected nominal return rather than the expected real return on investments.

Even in the absence of short-term capital flows, internal and external equilibrium cannot be achieved at the same time by adjusting interest rates, if inflation rates in the two countries diverge, for example, because of different institutional arrangements on the labour market. This is because the central bank cannot fight inflation without attracting capital inflows in the short term, and provoking volatility of capital flows and exchange rates in the medium term. Neither can it lower interest rates without running the risk of failing to reach the inflation target.¹⁹

Independently of whether a high-inflation country with a fully liberalized capital account chooses to fight inflation by maintaining high interest rates, or to keep the real interest rate at a level at least as high as in the low-inflation country, its currency will attract international investors in short-term assets. The high-inflation country can achieve domestic price stabilization only if it maintains nominal interest rates at a level higher than those of the low-inflation country. But if, in the short run, the inflation differential between the two countries is not matched by a corresponding expectation of depreciation of the high-inflation country's currency, the occurrence of a fundamental disequilibrium will be unavoidable. However, choosing the alternative approach and trying to fix the nominal exchange rate is, in this framework, also very costly. Intervention by the central bank of a developing country implies buying foreign currency against bonds denominated in domestic currency that bear relatively high interest rates, and investing the foreign currency purchased at a lower interest rate in the developed country. Thus a strategy of intervening in currency markets and accumulating foreign currency reserves amounts to a permanent subsidization of foreign investors with domestic taxpayers' money.

Free capital flows between countries with differing rates of inflation usually break the link between interest rate differentials and the risk of currency depreciation, because exchange rates do not follow PPP in the short term. Introducing PPP as a "theoretical norm" (Schumpeter, 1939) or a political target is the only way out. With exchange rate expectations being "rational" in terms of PPP, exchange rate expectations should always equal the interest rate differential and the price level differential. But this solution does not apply in

reality. Expectations are not formed rationally along the lines of PPP, as unhedged borrowing offers a short-term profit in most exchange rate regimes only if major imbalances have not occurred.

2. *Patterns of adjustment*

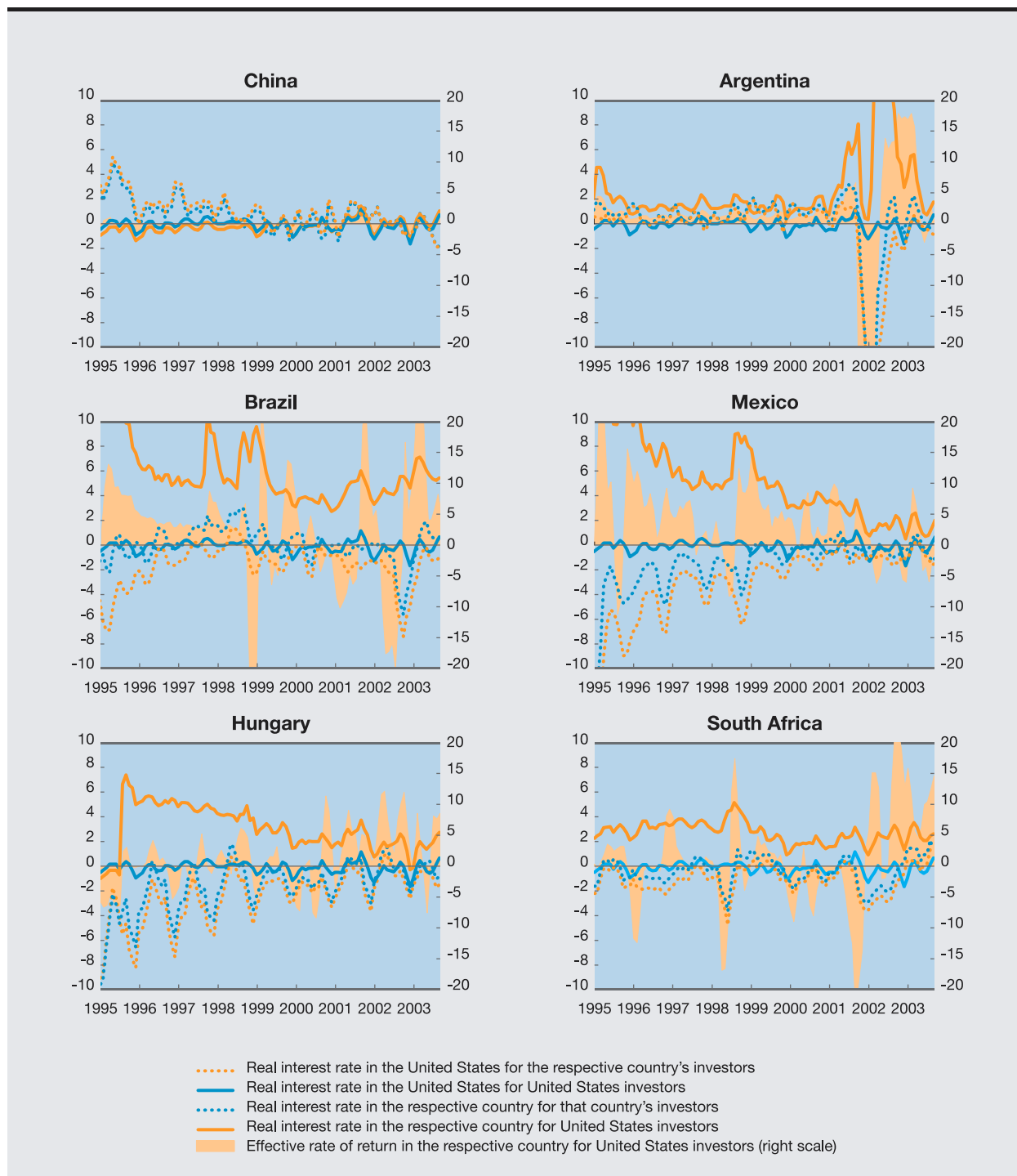
The UNCTAD secretariat conducted some calculations in order to examine the evolution of returns on short-term international portfolio investment in a number of developing countries over the period 1995–2003. As a first step, assuming exchange rates to remain stable, the real interest rate that is relevant for the decision of an investor from the United States to make, for example, a three-month investment in a developing country, is the three-month nominal interest rate in the developing country minus the inflation rate in the United States. International investors base their decisions on the inflation rate in their home country, and not on the rate in the country in which they invest, because they intend to reimport the invested money at the end of the investment period rather than to buy goods in the country in which they invest.²⁰

The results of these calculations are shown in figure 4.5 for six countries. The exchange rate regimes that govern the relationship between the dollar and the currencies of these six countries strongly differ. China has maintained a stable currency peg against the dollar for a long time. The figure indicates that from the financial side, this peg is sustainable, as China does not offer real interest rates for international investors that could directly endanger the peg. The incentive to invest in China on a short-term basis, as reflected by the line showing the real interest rate for United States investors, has consistently been either only marginally positive or even negative. By contrast, Mexico and Brazil maintained a very high real interest rate for international investors throughout the second half of the 1990s. Even Argentina maintained positive real interest rate differentials during this period – reflected by the difference between the two solid lines in the figure – despite its hard currency peg with the dollar. Indeed, the real interest rate that underlies decisions of United

Figure 4.5

INCENTIVES FOR SHORT-TERM INTERNATIONAL PORTFOLIO INVESTMENT IN SELECTED COUNTRIES, 1995–2003

(Per cent)



Source: UNCTAD secretariat calculations, based on data from IMF, *International Financial Statistics*; and Thomson Financial Datastream.

Note: The scenario that underlies the figure is based on a 3-month investment horizon. Real interest rates lower than minus 10 per cent or higher than plus 10 per cent, and effective returns lower than minus 20 per cent or higher than plus 20 per cent are not shown for expositional clarity.

States investors to invest in the Latin American countries has, in many instances, been much higher than in the United States over a long period. Thus transactions of a huge size must have taken place, assuming that the money and currency markets operated efficiently. The crises in Mexico (in the mid-1990s), Brazil (1999), and Argentina (2001–2002) demonstrate that, as a rule, financial crises and the collapse of the exchange rate are preceded by phases of enormous effective returns and extremely high interest rates for foreign investors. Only in 2002 did Mexico manage to bring inflation and its short-term interest rate down, and to avoid attracting foreign investors with offers of high financial yields. Brazil, on the other hand, still offers investors very attractive conditions.

In addition to the interest rates calculated at a fixed exchange rate, a second step in the calculations takes account of the actual change in the bilateral exchange rate in order to calculate the effective rate of return for United States investors in the developing country. This rate (shown by the shaded area in figure 4.5) reflects the *ex-post* observed change in the exchange rate, but provides no information on the rate that the investors expected. Indeed, the calculations are based on *ex post* known interest and exchange rates, which may differ from the rates the investors expected. As such, the results of the calculations do not allow any assessment of the actual size of capital flows that may have been induced by the configuration of these rates at any point in time. At some points there may have been huge flows, while at others there may have been no flows at all. While these limitations need to be kept in mind when interpreting the results, the calculations reveal the dilemma of developing countries that liberalize their capital account without being able to keep their inflation rate at the level of the developed economies.

Hungary and South Africa are examples of countries with rather flexible exchange rate regimes and high *de facto* exchange rate volatility. Since 2002, both countries have tried to reduce domestic inflation by maintaining relatively high interest rates. This has resulted in a decline in competitiveness due to real currency appreciation. Figure 4.5 shows that the real interest rate incentive for foreign investors is significant and induces

short-term capital inflows, causing an adverse impact on the real exchange rate. During 2003, for example, a three-month investment in South Africa could yield as much as 10 to 20 per cent, which may add up to an annual rate far beyond 50 per cent.

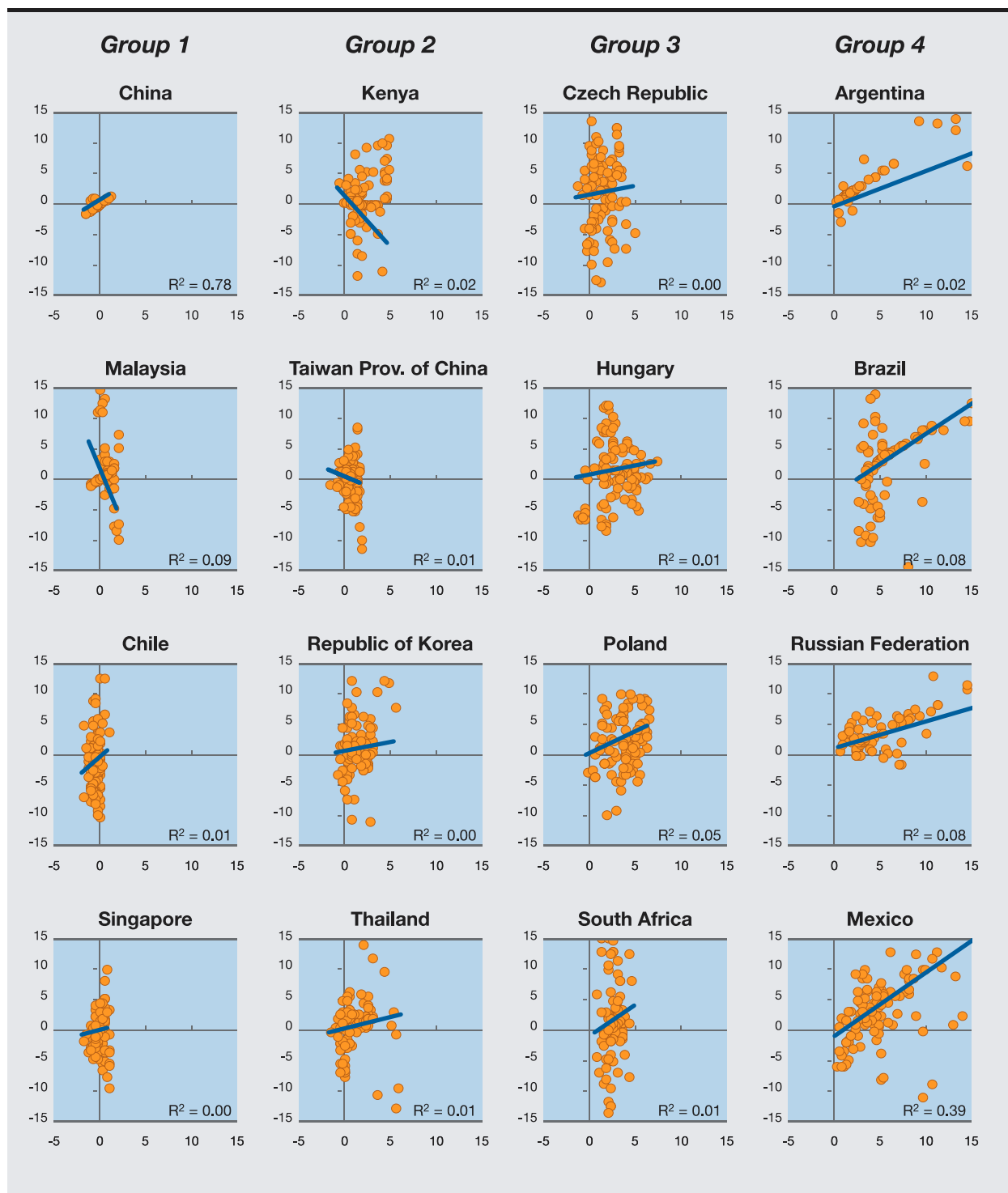
Argentina and Brazil followed similar approaches in the second half of the 1990s but with varying rigour. Argentina fixed its exchange rate very strictly to the dollar, offering a positive and, over many years, fairly stable real rate of return to foreign investors; this rate increased sharply in the run-up to the crisis of its currency board system and led to the collapse of that system. Brazil adopted a crawling peg, visible in the stable difference between the real interest rate for United States investors and the effective rate of return. This system *per se* was less restrictive than the Argentinean one on the external side, but had to be complemented by higher domestic interest rates to avoid a return of inflation. Under conditions of free capital flows, the Brazilian soft peg offered very high real rates of return until the beginning of the crisis in 1999. However, even after the crisis, the Brazilian central bank did not fundamentally change its policy of maintaining a high level of interest rates relative to that in the United States. The resulting recent rise in capital inflows has put sharp pressure on the Brazilian real to appreciate.

Looking at the experience of a larger group of economies, figure 4.6 reveals sharp differences in patterns of adjustment. In this figure, the real interest rate for a United States investor is correlated with the effective rate of return for that investor. The economies are grouped according to the attractiveness of their currencies for international portfolio investors. If the nominal exchange rate is perfectly stable, there is no scattering of the points and the correlation is very high, as is the case for China. The position of the curve (right of the zero point or on the zero point) indicates whether, in terms of the interest rate differential, the country has been attractive (Argentina, Brazil) or not (China) for international investors. In group 1 (column 1 of the figure), the countries aim at a rather low nominal interest rate, with or without fixing the exchange rates. In Malaysia, Singapore and Chile, the exchange rate is not as stable as in China, but these three countries' cen-

Figure 4.6

ALTERNATIVE EXCHANGE RATE REGIMES AND INCENTIVES FOR SHORT-TERM
PORTFOLIO INVESTMENT IN SELECTED ECONOMIES, 1995–2003

(Per cent)



Source: See fig. 4.5.

Note: For the calculation of the real interest rate and the effective rate of return, see text. Vertical scale: effective rate of return in the respective economy for United States investors; horizontal scale: real interest rate in the respective economy for United States investors.

tral banks avoid giving incentives to foreign investors to speculate on an overvaluation.

In group 2, the interest rate incentives are fairly small and the effective returns (including exchange rate changes) scatter quite remarkably along the vertical axis. This means that these economies – as demonstrated by the Republic of Korea, Taiwan Province of China and Thailand – avoid one-sided flows by maintaining high exchange rate volatility and low interest rates.

Countries in group 3, consisting mainly of transition economies, have adopted a floating exchange rate regime but with some interest rate incentives for international investors, as the inflation rate in these countries was relatively high during the 1990s.

The fourth group of countries follows a different approach. By keeping the exchange rate fairly stable and offering incentives for financial investors, their central banks try to use the exchange rate to stabilize inflation. This implies prolonged periods of rather risk-free arbitrage for international investors. These hard or soft pegs are sustainable only if the high interest rate does not depress the rate of domestic investment, or if an appreciation of the real exchange rate can be avoided. In most cases, however, these conditions do not apply. Sooner or later, the currency peg, soft or hard, has to be discontinued and replaced by a new system.

The examples of intermediate systems of managed floating (as in Poland, Hungary, the Czech Republic, South Africa, or in Brazil and Argentina after their currency crises) show that the variability of the exchange rate may increase the risk for the international investor at certain points, but it may increase the reward as well. If, for example, the country with the floating currency has been going through a crisis phase with real depreciation, the exchange rate expectation tends to turn around for a time, as the international investors expect revaluation and not a new devaluation. This has been the recent experience of Brazil and South Africa. To avoid a quick and strong real currency revaluation, which would destroy the gains in competitiveness the country has just achieved, the monetary authorities intervene by buying foreign currency and piling up interna-

tional reserves. This is costly for the country involved, as its interest rates are higher than the rates it can earn by recycling the money to the country of origin or to another safe haven. In these circumstances, it is difficult, if not impossible, to strike a balance between the domestic needs to fight inflation and the negative repercussions of incentives for foreign investors in portfolio capital on domestic growth and employment.

3. Multilateral solutions are the answer

The message of the preceding analysis is a simple one. If the nominal short-term interest rate in a financially open emerging-market economy exceeds that in a developed country by more than the growth differential, the nominal exchange rate of the former should depreciate at a (annual) rate that equals the difference in (annual) interest rates. If this is not the case, the situation is not sustainable, as either the high interest rate or the overvalued exchange rate hampers sustainable economic development in the emerging market economy.

Hence the political choice to combine floating of the currency with restrictive domestic monetary policy to bring down inflation will destabilize the external account. Speculation on uncovered interest rate parities will yield high returns to arbitraging international portfolio investors, as nominal and real interest rates in the developing economies are higher than in the leading industrialized economies. The currencies of the high-inflation countries will tend to appreciate, thereby, temporarily, even increasing the incentive for foreign investors to buy domestic assets and the incentive of domestic borrowers to borrow abroad.

Overall, the dilemma for developing-country policy-makers of a situation in which international investors earn high rates of return in their countries, despite falling real income, domestic profits and employment, cannot be resolved under conditions of free capital flows. Developing-country policy-makers are usually unable to reduce interest rates to stop the speculative capital inflow, because doing so would endanger the credibility of their monetary policy domestically. The political will to achieve economic stability is reflected

in the decision to keep nominal interest rates high. How long an external economic imbalance following an exchange rate peg or an appreciation can be sustained is an open question. With growing visible external imbalances the developing country's exchange rate policy will begin to lose credibility in markets. Once investors are convinced that the anchoring country will not be able to manage slowing down the growth of its external debt smoothly, confidence will deteriorate. This will lead to renewed crisis, a reduction of reserves and eventually a depreciation of the country's exchange rate.

In any case, exchange rate changes are necessary to compensate for the opening scissor blades of the price and cost developments between a high-inflation and a low-inflation country. As long as developing countries are not able to perfectly converge in nominal terms with the developed countries, devaluations are unavoidable in order to preserve the competitiveness of the high-inflation countries. However, exchange rate changes, and in particular, real exchange rate changes, that determine the competitiveness of the whole economy, cannot be left to the market. Given the arbitrage opportunities between high- and low-inflation countries, a rule of competitive neutrality of the exchange rate, like the PPP rule, has to be enforced by governments and/or central banks. Ideally, such a rule should be the result of multilateral agreements, as exchange rate changes always have multilateral repercussions. But if the international community is not able to agree on rules to avoid competitive devaluations and huge destabilizing shocks, countries will continue to manage the floating of their currencies unilaterally.

Managed floating, however, faces an adding-up problem on the global scale. Not all countries can simultaneously manage the movements of

their exchange rate and achieve their targeted rates. The exchange rate, by definition, is a multilateral phenomenon, and attempts by many countries to keep their currencies at an undervalued rate may end up in a race to the bottom – or in competitive devaluations – that would be as harmful for the world economy as in the 1930s. Moreover, given the size of international short-term capital flows and the inherent volatility of these flows, only those developing countries

that are big and competitive enough to withstand strong and sustained attempts of the international financial markets to move the exchange rate in a certain direction will be able to manage the floating successfully. A small and open developing economy will hardly be able to continue fighting a strong tendency to appreciate over many years or even decades.

Multilateral or even global arrangements are clearly the best solutions to this problem. The idea of a cooperative global monetary system would be to assure, on a multilateral basis, the same rules of the game for all parties involved, more or less in the same way as multilateral trade rules apply to every party equally. That is why the main idea behind the founding of the International Monetary Fund in the 1940s was to avoid competitive devaluations. In a well-designed global monetary

system, the need and the advantages of the currency depreciation of one country have to be balanced against the disadvantages to the others. As changes in the exchange rate, deviating from purchasing power parity, affect international trade in exactly the same way as changes in tariffs and export duties do, such changes should be governed by multilateral regulations. Such a multi-

lateral regime would, among other things, require countries to specify their reasons for real devaluations and the dimension of necessary changes. If such rules were strictly applied, the real exchange rate of all the parties involved would remain more

To combine floating of the currency with restrictive domestic monetary policy to bring down inflation will destabilize the external account.

If the international community is not able to agree on rules to avoid competitive devaluations, countries will continue to manage the floating of their currencies unilaterally ...

or less constant, as strong arguments for creating competitive advantages at the national level would rarely be acceptable.

In a world without a multilateral solution to the currency problem, the only way out for high-inflation or high-growth countries that are not members of a regional monetary union is to resort to controls of short-term capital flows or to follow a strategy of undervaluation and unilateral fixing.

... managed floating,
however, faces an adding-
up problem.

If developing countries are able to avoid destabilizing inflows and outflows, either by taxing those flows or by limiting their impact through direct intervention in the market, the hardest choices and misallocations due to erratic exchange rate changes can be avoided; but the resort to controls or permanent intervention should not replace the search for an appropriate exchange rate system at the regional or global level. ■

Notes

- 1 Local wholesale and distribution costs also affect trade costs. But since they apply to both imports and domestic goods, they do not affect relative prices to buyers and international competitiveness.
- 2 This is the case, for example, if wage increases are indexed to inflation, and if external supply shocks such as price increases of imports (e.g. oil) have a strong impact on inflation.
- 3 For example, according to Gordon (2003: 208), the average annual rate of growth of labour productivity in the United States during the period of the information and communications technology boom (1995–2000) was about 2.5 per cent.
- 4 See Forbes (2002a) for a theoretical model and econometric evidence for this argument.
- 5 However, as discussed in *TDR 1998* (chapter III), the sharp rise in domestic interest rates may prove largely unsuccessful in stopping the downward spiral in exchange rates, as demonstrated by the 1997–1998 East Asian crisis.
- 6 The conclusion that the finding of an adverse impact of exchange rate volatility on trade flows is not robust relies on the result of one out of seven regressions. This result has by far the lowest level of statistical significance among the regressions that rely on the chosen model specification. Moreover, the authors note that the set-up chosen for this regression may not be able to reveal the entire negative effect of exchange rate volatility on trade (IMF, 2004: 49–50).
- 7 This initial deterioration of the trade account following a real depreciation is known as the J-curve effect, and the mentioned elasticity condition is known as the Marshall-Lerner condition.
- 8 Ghei and Pritchett (1999) review the literature and discuss factors that determine whether real depreciations improve the trade balance in developing countries, as well as the empirical challenges in measuring these effects.
- 9 For a full discussion of this dilemma faced by many African countries, see *TDR 1998*.
- 10 Especially those by Glick and Rose (1999), Forbes (2002b), and Duttagupta and Spilimbergo (2004). Other studies find that trade linkages have some role, but are overshadowed by financial linkages and/or macroeconomic variables (*TDR 1998* (chapter II); van Rijckeghem and Weder, 2001; and Caramazza, Ricci and Salgado, 2004). Baig and Goldfajn (1998) are among the few authors who do not find support for the importance of trade in the international transmission of crises, but their evidence is contradicted by Duttagupta and Spilimbergo (2004).

- 11 Indeed, similar “paradoxes” regarding persistent external imbalances, in spite of substantial movements in relative exchange rates among major currencies, have become a frequent feature of the world economy. For example, the strong appreciation of the yen against the dollar in 1985 and 1994–1995 was not followed by a collapse in Japanese output of traded goods relative to the United States and other countries. Similarly, the recent strong depreciation of the dollar and the strong appreciation of the euro have had only a modest impact on trade flows. While the reasons for these developments are undoubtedly complex, incomplete exchange rate pass-through appears also to have played an important role in all these instances, as documented for Japan by Athukorala and Menon (1994) and Goldberg and Knetter (1997), and for the euro area by Faruqee (2004).
- 12 For the group of CEECs, the results indicate a statistically significant positive relationship between real currency appreciations and increases in export-market shares – a finding in line with the Kaldor paradox. However, as data for earlier years were not available, the results for the CEECs refer to a relatively short period (i.e. 1995–2002). More importantly, during the early 1990s these countries carried out major exchange rate depreciations to facilitate the massive industrial restructuring associated with their transition from a centrally planned system to a market economy system. In addition, their gain in market shares in world manufactured exports during the 1990s was in large part due to a reorientation of their trade flows towards developed and developing countries, and away from their traditional trading partners in the former CMEA. Intra-CMEA trade flows were not market-driven, and valuations on the basis of so-called transfer roubles were arbitrary. Conversion to dollar values were, moreover, complicated by inconsistent national rouble/dollar cross rates. These specific circumstances largely explain why the CEECs included in the sample experienced, on average, a combination of real currency appreciation and rising shares in world manufactured exports during the period 1995–2002.
- 13 This division is based on the country classification used in the UNCTAD *Handbook of Statistics*. Wollmershäuser (2004) uses different categories and classifies countries for each individual year, based on whether manufactures, fuels, or non-fuel primary products account for the highest share in the country’s total merchandise exports in a specific year. However, he obtains similar results.
- 14 This resembles the approach of Forbes (2002c: 218), who determined yearly dummy variables for depreciation events on the basis of monthly data, and defined a depreciation event as a 10-per-cent or greater increase in a country’s exchange rate versus the dollar in any four-week period during the sample period.
- 15 This is likely to reflect a decline in both imports and domestic income.
- 16 Diverging inflation trends in open economies are much more important for the viability of an exchange rate strategy than the usually discussed “asymmetric shock”, first introduced by Mundell in his paper on optimum currency areas (Mundell, 1961). With diverging inflation trends grounded in different labour market regimes, the arguments used to defend hard pegs or dollarization (e.g. Calvo, 1999) no longer apply, as long-lasting remedies to preserve competitiveness are sought and not just one-off measures.
- 17 The monetary policy rule presented by Taylor (1993) postulates that the central bank should base the setting of the short-term interest rate on the current situation with regard to inflation and the business cycle.
- 18 A striking example of this is Hungary’s recent switch from a crawling peg to a flexible exchange rate following a strategy of inflation targeting. Immediately after the move, although the country had an inflation rate of around 10 per cent (compared with 2 per cent in its main trading partner Germany), its currency appreciated sharply, as Hungary offered much higher nominal interest rates than Germany.
- 19 Laursen and Metzler (1950: 277–278) summarize the experience of the 1930s in a similar way: “Exchange rates at that time underwent frequent and substantial fluctuations ... the fluctuations that occurred nevertheless created serious doubts concerning the effectiveness of a flexible-exchange system in equalizing a country’s international payments and receipts”. They conclude that “a regime of flexible exchange rates would not be successful unless capital movements were subject to some kind of control”.
- 20 The same reasoning applies for a developing-country enterprise seeking a low-interest, short-term credit. In other words, the enterprise will have an incentive to obtain the credit in the United States if the nominal interest rate in the United States is lower than in its home country.

Annex 1 to chapter IV

THE CONCEPT OF COMPETITIVENESS

Linkages between investment, productivity growth, successful integration into the international trading and financial systems, and economic development have been seen in recent years through the lens of international competitiveness. A wide range of criteria and measures of the competitiveness of countries have been elaborated, some of which have been extensively publicized. Indeed, “competitiveness” has become not only a management buzzword, but also a term widely used in economics and economic policy-making.

The concept of competitiveness can contribute to an understanding of the distribution of wealth, both nationally and internationally, if it is recognized that: (i) it can be applied at both the enterprise and the country level, (ii) when applied at the enterprise level, it relates to profits or market shares, (iii) when applied at the country level, it relates to both national income and international trade performance, particularly in relation to specific industrial sectors that are important in terms of, for example, employment or productivity and growth potential, (iv) it is based on a Schumpeterian logic that sees the nature of capitalist development as a sequence of innovative investments associated with dynamic imperfect competition and productivity gains, and that sees a major role for public policy in facilitating productivity-increasing investment,¹ and (v) not all countries can simultaneously improve the competitiveness of their firms

or sectors relative to other countries, but all countries can simultaneously raise productivity and wages to improve their overall economic welfare without altering their relative competitive positions.

If new technology in the form of added capital per worker (or embodied technological change) is at the heart of the development process through which nations become rich, and if embodied technological change is driven by investment based on either innovation of domestic entrepreneurs or putting imported capital equipment to efficient use, then approaching the concept of competitiveness in the context of economic development needs to take account of the interdependence of investment, trade, finance and technology.

Looking at competitiveness from the perspective of interdependence, two key questions relate to how different price, wage, exchange rate and trade arrangements (i) influence the determinants of innovative investment, and (ii) determine whether productivity gains of individual firms translate into benefits for the overall economy, as reflected in rising living standards, while maintaining external balance.

Emphasizing interdependence also implies that competitiveness in international markets is determined by both real and monetary factors. Competitiveness may increase as a result of the

relatively strong productivity performance of companies or the national economy as a whole. But greater competitiveness can result also from a depreciation of a country's real effective exchange rate following either a depreciation of its nominal effective exchange rate or a smaller rise in the ratio between wages and productivity (i.e. unit labour costs) than in other countries.

There have been strong objections to the use of the concept of competitiveness at the level of countries rather than at the level of individual firms. Some of these objections raise valid concerns. Indeed, caution is needed in presenting the concept as one of the economic challenges facing developing countries. The first major objection is that countries, unlike companies, do not compete with each other (Krugman, 1994). This means that, strictly speaking, if the international mobility of labour was very high, and the monetary and trading conditions in the world economy mirrored exactly those that apply within national economies, the concept would be useful only to define the position of individual enterprises vis-à-vis each other. By contrast, it would not be useful for comparisons between national economies, or even between industries comprising many firms with different characteristics.

However, most of the factors underlying the competitiveness of individual enterprises are determined at the level of the national economy, implying that the national economy is indeed a meaningful entity for the concept of competitiveness.² More precisely, one characteristic of the world economy today is that labour mobility is much lower across, than within, countries. Where labour mobility is relatively low even within countries, rules and regulations that govern labour costs are designed to apply at the level of the national economy.³ Moreover, most national economies are individual currency areas, so that fluctuations and misalignments of nominal exchange rates directly influence the competitiveness of firms operating in different countries, even if factors determining competitiveness at the firm level are similar. Further, government interventions that affect the determinants of trade flows and exchange rates usually have a similar effect across all sectors and enterprises of the national economy. However, from an individual firm's perspective, it may matter little whether its international competitiveness

improves through productivity growth, lower labour costs or a devaluation of the currency. But from a broader, socioeconomic point of view, these have different implications for national economic development, as well as for systemic stability and welfare in the global economy.

The second major objection raised against the concept of competitiveness is that international trade is not a zero-sum game, and it is therefore meaningless to say that a national economy is becoming more or less competitive. In traditional trade theory, relative changes in the importance of different sectors reflect changes in relative resource endowments; in a general equilibrium framework, this simply implies a shift from one setting of optimal resource allocation to another. As such, sector-specific changes imply shifts in the countries' relative positions of comparative advantage, but the underlying general equilibrium framework does not allow for any definition of national competitiveness. However, as argued by Krugman (1996: 18), these mechanisms come into play only in perfect markets, while in imperfect markets, "involving imperfect competition, external economies, or both", there are valid concerns about national competitiveness. Of the many departures from perfect markets in actual economic relations – including scale economies, externalities and linkages, product differentiation, cumulative learning and first-mover advantages, and technological leads and lags – technology factors are of key importance in the concept of competitiveness, because it is mainly technological innovations that drive productivity gains, which provide the micro-economic basis for improved competitiveness.

All this implies that developing countries have valid concerns about their external economic performance. First, countries in the early stages of industrialization require foreign-exchange earnings from exports to finance machinery and equipment imports that enable innovative investors to obtain productivity gains. Second, countries further advanced in industrialization, and strongly integrated into international trading and financial markets, may find it difficult to maintain a sufficient degree of flexibility in their monetary, wage and trade policies. Flexibility is needed to accommodate price adjustments that arise from productivity-enhancing investment and to prevent profits earned through innovative investments from being spent on luxury

imports rather than being reinvested. Third, and most importantly, changes in the relative importance of different economic sectors are a key factor for rapid and sustained productivity growth and higher living standards. This implies that the concept of competitiveness is of immediate policy relevance. It can be used to analyse under which conditions productivity gains at the microeconomic level translate into structural change at the level of the national economy and enable upgrading of the technology content of a country's export basket. It is also useful for identifying policy measures that reduce the vulnerability of national economies to disturbances emanating from the international

economy and which may have adverse effects on national economic development.⁴

Given the complexity of the issue of competitiveness, it is not surprising that there is a multitude of competitiveness indicators. Some analysts use competitiveness indices that combine several dozens of individual measures spanning across a wide range of economic and non-economic factors.⁵ However, the indicator that is most widely used in applied economic analysis is the real exchange rate, based on either relative consumer price or relative unit labour cost indices expressed in a common currency.

1. Conditions for competitiveness at the microeconomic level

Linkages between capital accumulation, technological progress and structural change constitute the basis for rapid and sustained productivity growth, rising living standards and successful integration into the international economy. Investment holds a central place in this interplay, because it can simultaneously generate income, expand productive capacity, and carry strong complementarities with other elements in the growth process, such as technological progress, skills acquisition and institutional deepening.

However, a given rate of investment can generate different growth rates, depending on its nature and composition as well as the efficiency with which production capacity is utilized. Particularly important for productivity growth and structural change is investment in new techniques and/or new products. This is because new procedures generally reduce production costs of established products, while new products are often more attractive to consumers than any of the previously

available alternatives. Assuming constant wages, successful innovative investment will be reflected in growing market shares, if the investor chooses to pass on innovation rents in the form of lower prices; or it will lead to (temporary) monopoly profits, if the investor chooses to leave sales prices unchanged and enjoy innovation rents from the rising revenue-cost ratio until competitors succeed in imitating the innovator. Which of these strategies the investor chooses will depend on the intensity of competition. This means that in the microeconomic sphere, changes in competitiveness relate to changes in relative labour productivity across different firms, and that technological progress and the ensuing growth in labour productivity (i.e. the drivers of sustainably rising competitiveness) are associated with oligopolistic, rather than perfect, competition.

Innovative investment in developed countries extends the technological frontier. By contrast, in developing countries it generally relates to the

adoption, imitation and adaptation of technology invented elsewhere. While this does not affect the key importance of productivity-enhancing investment for competitiveness at the firm level, or significantly alter the determinants of investment decisions, there are three issues that specifically concern productivity-enhancing investment in developing countries. First, in building their industrial capacity and competitive strength, newly industrializing countries must typically import a large volume of capital goods and intermediate inputs. However, an inability to obtain additional export earnings (i.e. if the country's products are not competitive on international markets or face prohibitive market access or entry barriers), and thus to finance these imports, may be a serious constraint on the industrialization process. The extent of this balance-of-payments constraint and dependence of developing countries on foreign technologies embodied in imported capital goods are perhaps greatest during the initial stages of industrialization. However, the need for large-scale imports of machinery and equipment persists throughout much of the industrialization process, especially when catching up is based on imitating technological leaders.

Second, in addition to directly facilitating a rise in the level of technology used by domestic firms, developing-country imports of goods that embody foreign technology positively affect domestic imitation and innovation. For example, a notable feature of the process of technological improvement in the East Asian economies in the early stages of their industrialization was their emphasis on research and development (R&D) spending, not only for backward engineering but also to match or surpass the product quality of foreign manufacturers by adapting and improving imported technology. The former enabled firms, for example, to fully assess the merits of a new foreign technology and thus to determine whether to secure a licence or not, and to unbundle foreign technology, thereby enhancing their bargaining power in negotiating with suppliers. As the industrialization process unfolded and firms came to master imitation, an increasing share of R&D spending was channelled into own innovation (*TDR 1994*, Part Two, chapter one). Taking a wider geographical perspective, and looking at a

large number of countries from all developing regions, a recent empirical study (Connolly, 2003) also reveals the positive impact of technology imports from developed countries on domestic imitation and innovation in developing countries.

Third, the realization of technological improvements in developing countries is closely related both to the skill level of their labour force – which determines the amount and degree of sophistication of technology that can be adopted and efficiently used – and to managerial capabilities, which must meet the requirements to function effectively in new sectors and new markets. As such, technological upgrading in developing countries is usually associated with a painstaking and cumulative process of technological learning. Human capital formation, including through learning, is instrumental in preventing a decline in the marginal product of capital, despite the rapid growth in the capital-labour ratio generated by rapid accumulation of physical capital. It also helps prevent a decline in the marginal product of labour, despite the rise in wages that results in a higher standard of living.

The competitiveness of affiliates of foreign TNCs is likely to be significantly higher than that of domestic firms. Labour productivity in TNC affiliates tends to be higher than in their domestic counterparts, because they can combine the comparatively lower general level of labour costs in the host country⁶ with the advanced production technology and management techniques used in their home countries, and with supplies of raw materials and intermediate production inputs from the cheapest sources.⁷ Indeed, in the context of the concept of competitiveness, the decision of a foreign company to invest abroad is generally based on the objective to reduce unit labour costs in production. Setting aside other host country characteristics (such as income or corporate tax treatment or provision of infrastructure), this implies that for FDI to occur, the investor must expect the ratio between labour productivity and wages in the affiliate to exceed that in the parent company. In other words, if expected unit labour costs in the host country are lower than in the TNC's home country, the TNC will consider moving part of its production activities abroad.

2. Competitiveness of firms at the level of the national economy

At the level of the national economy, the decisive factor for realizing technological upgrading and productivity-driven structural change is the ability of investors to sell the products resulting from their product or process innovations without a significant change in cost conditions (i.e. to enjoy a (temporary) monopoly profit). In other words, if an economy is characterized by high domestic labour mobility and by a similar level of wages for workers with similar qualifications across the economy, its dynamic development will be driven by profit differentials, rather than wage differentials. Indeed, as noted by Keynes (1930: 141), “the departure of profits from zero is the mainspring of change in the ... modern world. ... It is by altering the rate of profits in particular directions that entrepreneurs can be induced to produce this rather than that, and it is by altering the rate of profits in general that they can be induced to modify the average of their offers of remuneration to the factors of production.”

Hence, the closer actual conditions on the labour markets get to the law of one price, the stronger will be the effects of profit differentials on the evolution of economic systems.⁸ The observed asymmetry between uneven productivity growth and the more even growth in wage rates across enterprises or industrial sectors is frequently emphasized as providing an important source of both structural change in the domestic economy and changes in the comparative cost advantages of different countries in specific industrial sectors. Uneven productivity growth across firms, combined with more even growth in wage rates, implies that workers in industries with rela-

tively high productivity growth are not fully compensated.

Under this scenario, innovative investors may decide to leave sales prices unchanged and obtain a sizeable extra profit equal to the difference between their productivity gain and the economy-wide average growth in productivity. Alternatively, they may prefer to reduce sales prices by the amount to which their cost per unit of output falls, and thus, assuming normal price elasticities of demand, increase their market share. This will lead to a rise in their absolute level of profits in line with the rise in sold output. This potential for extra profits is the major incentive for starting the process of “creative construction” or “destruction” along Schumpeterian lines, and hence for making innovative investments. By contrast, if wages in each firm rise more in line with firm-specific productivity gains, innovative investors will obtain a much lower extra profit, which will be much less of an incentive for innovative investment.

Enterprises whose productivity gains fall short of the national average will experience shrinking profits if labour costs rise at equal rates across firms. These enterprises will therefore attempt to raise the sales prices for their goods so as not to risk a complete erosion of profits.⁹ This implies that sectorally uneven productivity gains, combined with even labour cost increases across the entire economy, generate price pressures in non-innovative sectors. However, the net impact of this supply-side effect on price pressure depends on effects originating from the demand side. Rising labour productivity induces increases in income,

and hence consumption. If demand for innovated and non-innovated goods were to grow at the same rate, demand effects would not skew price pressure towards one or the other group of goods, thus the supply-side effect would dominate. By contrast, if demand for the innovated good were to grow faster than for the other goods, the supply-side effect would be offset, partly or completely. And if demand were biased towards goods for which productivity gains were low (such as services), the demand effect would reinforce the supply effect. This will be the case particularly when productivity gains are high in the traded sector, while domestic consumption demand is biased towards non-traded goods.

A second important condition for innovative investment to govern the evolution of the economic system is that firms should have access to reliable, adequate and cost-effective sources for financing their investments. This condition is best met when profits themselves are the main source of investment financing. Indeed, if an investment-profit nexus can be ignited, profits from innovative investments simultaneously increase the incentive for firms to invest and their capacity to finance new investments.¹⁰ When enterprises are heavily dependent on borrowing to meet their needs for fixed investment and working capital, as is the case of new enterprises, the stance of domestic monetary policy is of crucial importance, because high levels of nominal and real interest rates tend to increase production costs. In addition to its adverse impact on the cost of capital, a restrictive monetary policy may bias investment decisions in favour of financial assets, or fixed investment in production activities with known cost and demand schedules over innovative production activities for which investors face uncertainty as to the volume of sales and the true costs of production.

To understand how the mechanisms discussed in this annex work in practice, it is useful to consider a two-country world comprising a developing country, with a low average level of both labour costs and labour productivity, and a developed country, with a high average level of labour costs and labour productivity. Expressed in a common currency, these levels are assumed as 5 and 10 in the developing country and 50 and 100 in the developed country (case 1 in table 4.A1). Further, assuming that in both countries the average

level of labour costs reflects the average level of labour productivity, firms in both countries face the same average level of unit labour costs (i.e. 0.5 currency units). If labour is the only internationally immobile production factor, these assumptions imply that firms from both countries are, on average, internationally competitive. Moreover, if firms set sales prices on the basis of a mark-up of 100 per cent over labour costs, the absolute level of profits in the developed country will be 10 times higher than in the developing country.¹¹

Case 2 in the table introduces the effects of innovative investment by assuming that productivity increases by 20 per cent in innovative firms of both countries. If the weight of these firms in their domestic economies is too small for these productivity gains to have a marked impact on the economy-wide average level of productivity, nominal labour costs will remain unchanged, and unit labour costs in the innovative firms will decline by 20 per cent. Profits per unit of output will also remain unchanged if the innovative firms reduce their sales prices in line with the decline of their unit labour costs. This implies that the innovative firms from both countries will experience an increase in both their export-market shares and their absolute level of profits. By contrast, non-innovative firms will suffer a decline in export-market shares and in profit levels due to the increase in their sales prices relative to those of the innovative firms.

Case 3 in the table shows that affiliates of TNCs can gain considerable advantages in international competitiveness by combining developed-country technology with developing-country labour costs. The level of the affiliate's unit labour costs will be substantially lower than that of either its parent company in the developed country or of domestic firms in the developing country. While it is unlikely that the relatively less educated workers in the developing country can match the productivity level of workers in the developed country, it is probable that the TNC will experience a strong reduction of its unit labour costs by moving its labour-intensive production activities to a low-wage country.

Changes in the nominal exchange rate that are caused by "autonomous" capital flows (i.e. that are unrelated to the flow of goods) can offset the

Table 4.A1

	Case 1		Case 2				Case 3
	No innovative investment		Innovative firm average ^a		Non-innovative firm average		TNC affiliate investing in developing-country export-oriented production
	Developing country	Developed country	Developing country	Developed country	Developing country	Developed country	
Productivity	10	100	12	120	10	100	120 > productivity > 10
Nominal labour costs	5	50	5	50	5	50	5
Unit labour costs	0.5	0.5	0.4	0.4	0.5	0.5	0.5 > ULC > 0.04
Profits per unit of output	5	50	5	50	5	50	115 > profits > 5
Price	1	1	1-x	1-y	1+x	1+y	1-z
1. Unchanged nominal exchange rate							
Export market share	unchanged	unchanged	up	up	down	down	up
2. Nominal exchange rate^b appreciation by more than 20 per cent							
Export market share	down	up	down ^c	up ^c	down ^c	up ^c	up
3. Nominal exchange rate^b depreciation by more than 20 per cent							
Export market share	up	down	up ^c	down ^c	up ^c	down ^c	up

Source: UNCTAD secretariat calculations.

Note: x and y are the shares of the innovative investors' products in the total consumption of their respective economies. z is the share of the multinational firm's reimported product in the total consumption of the economy of the parent company.

- a** The scenario in the table is based on the assumption that innovative investors fully transmit gains in profits per unit of output into price reductions.
- b** Developing-country currency/developed-country currency.
- c** The net effect depends on the relation between the gain in productivity and the exchange rate misalignment. The assumption for the effects noted in the table is that the misalignment is far greater than the gain in productivity.

effects discussed above. In case 1, export-market shares will move from firms of the country whose currency appreciates towards firms of the country whose currency depreciates, even though none of the firms has undertaken productivity-enhancing investments and unit labour costs, measured in domestic currency units, have not changed in any of the firms. More importantly, the innovative firms in case 2 will lose, rather than gain, export-market shares if the appreciation of the exchange rate exceeds productivity gains. For example, assuming

the currency of the developing country to appreciate by more than the productivity gains achieved by innovative firms, these firms will lose export-market shares to both the innovative and non-innovative firms of developed countries. This example shows that adverse external monetary shocks can wipe out the gains resulting from an improvement in the international competitiveness of developing-country exporters based on innovative investments and a decline in unit labour costs. ■

Notes

- 1 Fagerberg, Knell and Srholec (2004) present a similar argument.
- 2 The major exception is labour productivity, which can be measured at the level of enterprises and industrial sectors, as well as at the aggregate level of the national economy. Other exceptions include firm-specific capabilities to access international markets.
- 3 In some countries, such as Germany, such rules and regulations apply at the level of industrial sectors, but developments in leading sectors have a strong impact on other sectors.
- 4 The concept of competitiveness as defined here is relevant for countries where economic success depends on investment that leads to sustained improvements in productivity. This excludes many of the poorest countries, where capital accumulation can help raise per capita income and living standards simply by allowing a fuller use of underutilized labour and natural resources without altering the efficiency with which resources are utilized.
- 5 Probably the two best-known competitiveness indices, contained in *The Global Competitiveness Report* of the World Economic Forum and in *The World Competitiveness Report* of the International Institute for Management Development, are frequently invoked in policy discussions and economic policy-making. But the way these indices combine the very wide range of individual indicators is not transparent and, more importantly, the complex theoretical issues that underlie the concept of competitiveness are insufficiently discussed. However, Lall (2001) has significantly contributed to a clarification of how these indices are actually constructed.
- 6 If labour mobility within the host country is high, the wage level will be determined by the economy-wide average level of labour productivity, rather than by marginal labour productivity.
- 7 The development effect of FDI for the host economy depends on a range of factors, including the amount of technological spillovers from affiliates to domestic enterprises, the creation of forward and backward linkages, and the effects on domestic investment. The large body of literature on this, including successive UNCTAD *World Investment Reports*, provides ambiguous findings, and shows that much depends on host-country characteristics and the way foreign affiliates operate.
- 8 Looking at developed countries, Scarpetta and Tresselt (2004) point out that in addition to wage bargaining regimes, two main aspects of labour-market policy and institutional settings are closely related to the incentives for firms to undertake investment with a view to expanding and innovating production facilities: (i) the stringency of employment protection legislation, which influences the costs of hiring and firing, and (ii) the possible interactions between this legislation and industry-specific technology characteristics. However, a discussion of the importance of these factors for developing countries is beyond the scope of this Report.
- 9 Note that this example assumes that the innovative and the non-innovative firms operate in different sectors, so that they are not in direct competition. If they operated in the same sector, an attempt to raise sales prices would make the non-innovative firm even more likely to be driven out of the market.
- 10 As argued by Akyüz and Gore (1996), the presence of such an investment-profit nexus played an important role in East Asian industrialization. The investment-profit nexus played an important role also in the growth performance of Western Europe during the three decades after the Second World War.
- 11 However, the developed country will tend to employ a higher stock of capital in production than the developing country. Thus the rate of return over capital (i.e. the absolute profit relative to the value of the capital stock) may be very similar in the two countries. In other words, the example relies on the assumption that the internationally immobile factor – labour – absorbs the entire wealth difference between the developed and the developing country, while the internationally mobile factor – capital – obeys the law of one price.

THE SET-UP OF ECONOMETRIC ESTIMATES OF THE IMPACT OF EXCHANGE RATE CHANGES ON TRADE PERFORMANCE

This annex details the set-up of the econometric estimations of the impact of exchange rates on the trade performance of developing countries and CEECs. The results are discussed in section B.2.¹ The basic objective of these panel data estimations is to assess how changes in the competitiveness of producers in an exporting country affect the country's merchandise trade performance. The estimations refer to annual data for the period 1970–2002, based on a sample that includes 22 developing economies and six CEECs; for the latter countries data availability restricts the time period to 1994–2002. This sample of 28 countries includes the 30 leading developing-country exporters, except Nigeria (which exports virtually only crude petroleum, so that its export performance is determined mainly by supply and demand in the global oil market), and the 10 leading CEEC exporters in 2001 for which data on real effective exchange rates were available.²

Competitiveness is measured by the exporting country's real effective exchange rate (*REER*) based, in most cases, on relative consumer prices.³ One of the advantages of using real-exchange-rate indices based on relative consumer prices is the ready availability of data. On the other hand, consumer price indices include not only domestically produced traded goods, but also non-traded domestic as well as imported goods. An alternative measure of REERs is based on relative unit labour costs of different countries, defined as the

ratio of employee compensation (including non-wage labour costs) per employee and the volume of output (value added at constant prices) per employee expressed in a common currency. Thus relative unit labour costs depend on relative labour costs per worker, relative labour productivity and the exchange rate. As such, a 10-per-cent slower rise in nominal labour costs, a 10-per-cent depreciation in the exchange rate or a 10-per-cent faster increase in labour productivity all have an identical impact on measured relative unit labour costs. Moreover, the real exchange rate based on relative unit labour costs allows for the decomposing of changes in international competitiveness into the relative impact of changes that emanate from the domestic economy (i.e. productivity gains and nominal wage changes) and those that have their origin in international relations (nominal exchange rate changes).⁴

The above implies that, conceptually, real-exchange-rate indices based on relative unit labour costs are the preferred measure of competitiveness, in particular for economies with a well-established industrial base and strong backward linkages. However, they tend to overestimate the impact of exchange rate changes on the competitiveness of domestic exporters to the extent that exports rely on imported intermediate inputs. A relatively high import content of exports offsets, to a considerable degree, the competitive edge provided by nominal currency depreciations.

Moreover, comprehensive data required to calculate relative unit labour costs are not available. This explains why empirical assessments of changes in real exchange rates usually rely on changes in relative consumer prices.⁵

The exchange rate data used for the estimations are taken from JP Morgan (2003), which cover both a wider range of countries and, for most countries, except for China, the Czech Republic, Hungary, Poland and Slovakia, a longer time period than the IMF's *International Financial Statistics*.⁶ Trade performance is measured by four variables: (i) the merchandise trade balance (*MB*) expressed as the ratio of exports to imports; (ii) total merchandise exports as a percentage of nominal income (*EX*); (iii) total merchandise imports as a percentage of nominal income (*IM*); and (iv) a country's market share in total world manufactured exports (*SHARE*). The current account balance, expressed as the ratio of exports to imports, is included as a fifth dependent variable. Given that cross-country variation in the rate of real income growth is likely also to influence countries' trade flows, the estimated equation also includes real world income expressed in dollars

(*WORLD*), and the exporting country's real income expressed in domestic currency (*GDP*). All trade and income data are taken from the UNCTAD *Handbook of Statistics*; current account data are from the IMF's *International Financial Statistics*. The equation is estimated as changes in underlying values in order to eliminate statistical problems, such as non-stationarity, and to allow interpreting the estimated coefficients as elasticities. It can be expressed as follows:

$$d(\ln TRADE_{it}) = \alpha + \beta d(\ln REER_{it}) + \delta d(\ln GDP_{it}) + \gamma d(\ln WORLD_t) + \varepsilon_{it}$$

where *TRADE* represents the four trade performance variables, *i* and *t* denote exporting countries and time periods, and ε is an error term. All variables are expressed as logarithms. All estimations were done with both the generalized least square method (GLS) in its simple form (i.e. a common intercept for all countries) with cross-section weights, and GLS with fixed effects (i.e. allowing intercepts to vary across countries). Since tests revealed the presence of fixed effects, only the results of fixed-effect estimations are reported.⁷ ■

Notes

- 1 This framework is partly based on Wollmershäuser (2004) who also presents a more comprehensive discussion of this relationship.
- 2 The 22 developing economies are Argentina, Brazil, Chile, China, Colombia, Egypt, Hong Kong (China), India, Indonesia, Malaysia, Mexico, Morocco, Pakistan, the Philippines, the Republic of Korea, Saudi Arabia, Singapore, South Africa, Taiwan Province of China, Thailand, Turkey and Venezuela; and the six CEECs are the Czech Republic, Hungary, Poland, the Russian Federation, Slovakia and Slovenia. For some countries, the first year for which exchange rate data are available is after 1970, namely China (1980), the Czech Republic (1990), Egypt (1994), Hungary (1980), Poland (1980), the Russian Federation (1994), Slovakia (1990), Slovenia (1994) and Turkey (1994).
- 3 See JP Morgan (2003: 20) for a list of which price index was used for which country.
- 4 Some analysts, such as Boltho (1996), have argued that using the real exchange rate as an indicator for competitiveness reflects short-term macroeconomic management concerns. However, when countries are subject to frequent external shocks, such as significant volatility in the nominal exchange rate or in commodity prices – that have an adverse effect on the country's terms of trade – or lasting exchange rate misalignments, concerns about the level of the real exchange rate also reflect long-term development objectives.
- 5 However, Turner and Golub (1997) show that, for most countries for which comprehensive data are available, there is a substantial positive correlation between the two measures of real exchange rates, even though large differences between the two measures occur over the medium term, in particular for developed countries.
- 6 For the 16 countries included in the sample for which data are available from both sources, the correlation coefficient between IMF and JP Morgan data exceeds 0.95 for 11 and averages 0.75 for the remaining 5 countries.
- 7 Tests showed that correction for autocorrelation is not necessary. Heteroskedasticity was corrected by using White's covariance estimator.

CONCLUSIONS AND POLICY CHALLENGES

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

A key objective of the initial set-up of the post-war multilateral trading system, which adopted the tariff as the only legitimate trade policy measure, was that the allocation of resources on the basis of comparative advantage should not be distorted by selective government intervention. The principle of unconditional, non-discriminatory treatment was an essential component of the tariff-based system. It ensured that all signatories to the GATT would be subject to the obligations resulting from

multilaterally negotiated tariff concessions, thus imparting a greater degree of security to the concessions. Special and preferential treatment and other trade preferences in favour of developing countries constituted a variation of, but not a departure from, the basic principle underlying this approach.

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

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

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

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

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

Otherwise, developing-country policy-makers who have adopted financial liberalization at an early stage of their integration process may

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

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

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

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

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

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

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

Note

1 Moreover, according to Gourinchas and Jeanne (2004: 23), “it has been argued that far from inducing discipline, the disruption induced by capital

flows could have deleterious effects on domestic institutions, policies, and growth.”

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