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**The Interface Between International Finance
and International Trade and Economics**

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Master of Business in International Economy

Master's Thesis: "The Interface Between International Finance and International Trade and Economics"

A. Literature Review

Interface between international finance, trade and development is a current theory whose aim includes the interpretation of the current events on the international sphere in terms of development, economic conditions, social scenarios, and political and cultural influences. This process of integration, as a set of theoretical claims, underlines especially increasing trends in fluent economic conditions, especially high mobility of financial resources and trade. The Monterrey Consensus also reaffirmed similar commitment to interface "to trade liberalization and to ensure that trade plays its full part in promoting economic growth, employment and development for all." It also welcomed WTO decisions "to place the needs and interests of developing countries at the heart of its work program, and commit to their implementation. By reaffirming commitment to trade liberalization and reiterating the importance of a rule-based, nondiscriminatory multilateral trading system, the Monterrey Consensus has pointed out a very important route to worldwide prosperity and poverty eradication- liberalizing trade in areas particularly important to poor countries. This will not only significantly help developing countries to grow and achieve the Millennium Development Goals(MDGs) but will also add to the welfare of the developed countries, leading to a better allocation of resources and aiding consumers and tax payers in these countries through lower prices for food and other goods, and lower public expenditures on subsidies.

Recent WTO, World Bank and IMF researchers have devoted much attention to trade issues- in particular, the relationship between trade, economic growth, and poverty reduction, and the costs and benefits likely to accrue to low income countries that liberalize their trade regimes. Economists have long observed that countries and regions that are linked by common institutions, currencies, or policies, and that enjoy relatively free access to each other's markets, tend to converge to similar levels of income over time. Between 1960 and 1982, for example, the incomes of poorer regions or countries converged to those of richer ones at a rate of about 2 per cent a year in the United States and different parts of Europe and among members of the Organization for Economic Cooperation and Development (OECD). (Andrew Berg and Anne Krueger, 2003).Indeed, poorer countries and regions have, in general, grown faster than their richer neighbors with which they have close ties. It is plausible that trade openness- the extent to which nationals and foreigners can trade with each other without artificial constraints (such as tariffs and quotas)- has played a role in the convergence process by facilitating specialization and promoting competition and the transfer of knowledge.

Nonetheless, case studies support the argument that trade liberalization raises growth rates. Although opening up to trade does not guarantee faster growth, all of the countries that have taken off economically in the past 20 years have included trade opening in their reform packages. Two seminal studies in 1978 analyzed the phases through which liberalizing countries moved as they shifted from import substitution to outward-oriented trade policies (that is, policies without an anti-export bias). Jagdish N. Bhagwati, 1978.

The studies described how the distortions caused by various protectionist measures worked their way through the economy in mostly unplanned and undesirable ways and showed how exports and growth responded to substantial trade liberalization and appropriate macroeconomic policies.

A major World Bank study that analyzed the design, implementation, and outcome of 36 trade liberalization episodes in 19 countries between 1946 and 1986 found that strong and sustained liberalization episodes resulted in rapid growth of exports and real GDP.

A study carried out in 1994 found that, among relatively closed economies, the poorest in 1960 also grew the slowest between 1960 and 1985, but that low initial income was *not* correlated with slower subsequent growth in open economies. In closed economies, low initial income reduces potential benefits from scale economies, but trade openness, by allowing access to broader markets, overcomes this problem. (Armeane M. Choksi, Demetris Papageorgiou, and Michael Michaely, 1991)

More recent microeconomic studies have documented several channels through which openness leads to higher productivity, including the import of machinery and equipment, which is usually accompanied by the transfer of know-how. Other studies have shown that import competition lowers margins and increases turnover and innovation. (Alberto F. Ades and Edward L. Glaeser, 1999)

The fundamental premise is that an increasing degree of integration and interface in capital flow and international trade plays a crucial role in economic development. This premise is widely accepted. However, there is much less consensus on its fundamental organizing principles and laws of motion. Neoclassical economic theories that are based on comparative advantage (Klein, Pauly and Voisin 1985), international relations approaches that stress geopolitics (Keohane 1993, and Thompson 1991), and world-systems perspectives that emphasize "unequal exchange" (Amin 1989; Frank 1979; Wallerstein 1991) offer contrasting models of the international system.

In terms of the interface and integration process that is taking place under current worldwide economic conditions, the main topic in international political economy is: how the structure of international economic system has changed. They can be addressed through the application of the interface and integration from the

development perspective. The basic claim is that international connections, roles, and relationships are important variables in any analysis which tries to explain various dimensions of development economic growth, for example- trade and financial links among countries.

Through the process of integration and interface, the assumption is that more nations are depending on worldwide conditions in terms of the international financial system, and trade. Therefore, the world scenario is more integrated in international economic transactions (Sunkel: 1995; Carlsson: 1995; Scholte 1995). Effects and influences from these "integrational aspects" can be studied from two major perspectives: (a) countries' external level -or systemic approach-; and (b) domestic or internal conditions within nations -sub-systemic approach. In the case of the latter, the units of analysis will be those corresponding to national variables of economic growth, or social indicators.

The main areas under dispute concerning the interface between international finance and trade are related to four main aspects: (a) The fact that countries can have more than three levels of placement: core, semi periphery, and periphery countries (Schott 1986); (b) The positional characteristics of several countries in terms of sharing the same patterns of relationships can be related to the "clique" characteristics with other nations at a regional level (Snyder 1989); (c) Even inside the same position within international relations, i.e. the periphery position, the features of countries might have a lot of variation in terms of the size of their economies, internal effective demand, export structure, and level of historical and/or current economic growth (Smith 1992); and (d) There is strong evidence that the patterns of economic concentration among nations especially in the fields of international trade and financial systems, are related to the dependent development patterns claimed by the neostructuralist authors (Cardoso 1992).

In more specific terms, it is important to mention that the interface approach implies a key element concerning integration -integration regarding international trade, the international financial system, from the more developed countries (DeMar 1992; Carlsson 1995). Economic integration at the systemic level -among countries- means stronger worldwide relationships. At the sub systemic level -within individual countries- it implies social and economic integration from the different social sectors (Sunkel 1995). At the systemic level there are some nations which are able to achieve more integration into the new world economic conditions than other countries. At the sub systemic level there are some social sectors which integrate themselves into the new economic dynamic derived especially from the economic growth, and sectors which become more marginalized in social terms (Sunkel 1995; Paul 1996; Scholte 1996).

The process of integration and world-systems theories, and to some extent, the dependency approach, take into account the most recent economic changes in world structure and relations that have occurred in the last two decades; for example: a) In March 1973, the governments of the more developed nations, began to operate more

flexible mechanisms in terms of exchange rate control. This situation allowed for a faster movement of capital among the world's financial centers, international banks, and stock markets; b) Especially since 1976 trade transactions base their speculations on the future value of the products, which is reinforced through the more flexible use of modern technology in information, computers, and in communication systems;

Economic theory suggests that capital will move from countries where it is abundant to countries where it is scarce because the returns on new investment opportunities are higher where capital is limited. Such a reallocation of capital will boost investment in the recipient country and, as Summers (2000) suggests, bring enormous social benefits. Underlying this theory is the premise that returns to capital decrease as more machinery is installed and new structures are built, although, in practice, this is not always, or even generally, true. New investment is more productive in countries with a skilled workforce and well-developed physical infrastructure, as Lucas (1990) recognized in explaining why capital does not flow from rich to poor countries. Thus, a consistent finding is that new capital flows tend to go to countries that have received large flows in the past and that investors also seek favorable business environments (Mody and Srinivasan, 1998). It is therefore not surprising that capital flows to low-income countries are declining.

In a literature review on the relationship between capital flow and economic growth, Levine (1997) and Demirguc-Kunt (2006) conclude that causality runs from capital flows to economic growth. They both present the theories explaining why capital flow has a positive effect on export-orientation and economic growth. Their empirical evidence also supports this argument. Their empirical analyses have been classified in three types of data: cross country, panel, and firm/industry. Panel and firm/industry data analyses are superior to cross country data analyses because they allow researchers to incorporate time series techniques and to control better for cross-country heterogeneity.

According to Levine (1997) capital flow "facilitate the allocation of resources, across space and time, in an uncertain environment". Therefore, the level of development in the financial sector plays a crucial role in the economy because any entrepreneurial and trading activity will depend on it. Furthermore, financial development promotes economic growth because it decreases market frictions that result from imperfect information (Khan & Senhadji, 2000). Financial intermediaries connect savers with investors in an efficient way and allocate resources to profitable projects (Demirguc-Kunt, 2006). Khan and Senhadji (2000) use a cross section sample and a five year average panel of 159 countries during the period of 1960-1999 and show the positive effect financial development has on economic growth. Several empirical analyses that use cross section and panel data find a positive effect of financial development on economic growth and are reviewed by Demirguc-Kunt (2006).

There is a debate on the relationship among capital flow, international trade development and economic growth leading to economic development. Some argue that capital flow both short-term and long-run causes international trade. Export oriented trade led to inclusive economic growth and others argue that economic growth causes capital flows. Most literature and empirical work agrees with the idea that a developed financial system fosters economic growth. Supporters of this view state that capital flows help to increase economic activity, and they base their argument on Schumpeter's view of financial development as "creative destruction" that allows the formation of new ideas (Rajan & Zingales, 2003). Nonetheless, there are other analyses showing that financial development may be the consequence of economic growth because developed economies create the demand for developed financial sectors (Shan et al, 2001; Shan, 2005).

Analyses at the firm/industry level also support the argument that capital flow is conducive to growth. For example, Rajan and Zingales (1998) argue that capital flow is beneficial because it allows firms to have a source of financing at a lower cost and to avoid moral hazard and adverse selection problems. Rajan and Zingales (1998) also show that capital flow is beneficial to those industries that rely on external financing. Furthermore, Beck (2002) argues that there is a positive relationship between financial development and exports of manufacturing goods because, with a more developed financial system, manufacturing industries have a comparative advantage (manufacturing industries usually depend on external financing). According to Carlin and Mayer (2003), capital flow also has an impact on investment in those industries that rely on external financing extensively. Love (2003) finds support to the positive effect of capital flow on economic growth in an empirical analysis that uses data from 5000 firms in 36 countries. He argues that capital flow reduces the cost of capital, and this allows firms to allocate investment more efficiently.

There are several channels through which international finance has been associated with economic growth. For example, it has been stated that capital flow promotes productivity growth and capital accumulation (Rioja & Valev, 2004a). By promoting higher productivity growth and capital accumulation, capital flow helps less developed countries (LDCs) to converge (Aghion et al., 2005). Financial development promotes technology transfer because technological knowledge is usually specific and requires intensive amount of capital. Aghion et al. (2005) present the theoretical model and empirical evidence on how financial development helps poor countries to converge.

Furthermore, using theoretical models and empirical evidence, it has been argued that capital flow decreases income inequality. Clarke et al (2003) posit that there is a negative relationship between capital flow and income inequality since financial market imperfections promote a more unequal distribution of wealth. It is stated that if the financial sector is underdeveloped, the initial level of inequality will continue because wealthy people will lobby for policies that benefit themselves, while the poor will be unable to augment their wealth because of the imperfections in the financial market (Li

et al, 1998). If the financial sector is underdeveloped, there is credit rationing, which makes it nearly impossible for the poor to finance schooling or other investments (Bigsten and Levin, 2001). Under this argument, the underdevelopment of the financial system contributes to the perpetuation of income inequality because human capital is not good collateral, and people with no assets are unable to finance schooling. Based on this particular case, findings suggest that in order to increase the income of the poor it is important to increase the access of the poor to capital through a more developed financial system. Financial development has not only been considered as pro-growth, but also pro-poor because of its effects on income inequality. Honohan (2004), using data on the infrastructure financial development decreases inequality by increasing the income of the poor. Beck et al. (2004) also find that financial development affects other social indicators such as infant mortality and school enrollment rates. They find that an increase on financial development decreases infant mortality and increases school enrollment.

The literature previously reviewed supports that financial development has a positive effect on economic growth. Nonetheless, it is important to mention that some of the empirical work previously mentioned has taken into consideration that there is a reverse causality issue between financial development and economic growth (Beck et al, 2004; Eschenbach, 2004; Honohan, 2004; Khan & Sehandji, 2000). As stated by Shan et al. (2001), the relationship between financial development and economic growth may be a “chicken or the egg” problem since financial institutions are usually developed in developed countries (DCs) and underdeveloped in LDCs. For example, financial development has been associated with stronger property rights (Acemoglu & Johnson, 2005; Claessens & Laeven, 2002). Since property rights have an impact on asset allocation, stronger property rights improve the access to financing. Because property rights and other institutions are sometimes determined by growth, financial development may just be the result of economic development.

To determine the real effect of financial development on economic growth, two things are required. First, it is necessary to determine whether financial development is endogenously determined in the growth equation. Second, if empirical evidence shows that financial development is determined by economic growth (reverse causality issue), analyses must incorporate techniques that address for this. For example, Khan & Sehandji (2000) argue that financial development is endogenously determined in the growth equation and use an instrumental variables (IV) approach. To address for the causality issue, Shan (2005) uses vector auto-regression (VAR) estimation in his analysis. While Khan & Sehandji (2000) use a large sample that includes DCs and LDCs and find a positive effect of financial development on economic growth, Shan (2005) uses a sample that includes 9 developed countries and China and finds that the effect of financial development on economic growth is insignificant. Furthermore, Rioja and Valev (2004b) use a generalized method of moments (GMM) technique and find that the effect of financial development varies across countries. They find that financial development has a positive effect on economic growth only for countries with high and intermediate

levels of financial development and no significant effect on those countries with low levels of financial development.

The debates on determining what comes first, financial development or economic growth, and on whether financial development has a positive effect on economic growth are far from being over. Arriving at a consensus is relevant for Latin American countries since they have undergone significant reforms in the financial sector, and it is necessary to determine whether further reforms to this sector are conducive to growth. Furthermore, because Latin America is the most unequal region of the world, it is also important to find out if financial reforms promote a more equal distribution of income in the region. Since it has been argued that educational attainment affects income inequality, it is also important to determine the effects of financial development on education. Using Latin American countries in the analysis is useful because the region is financially underdeveloped, and the financial sectors in these countries share similar characteristics.

Economies with better developed financial sectors have a comparative advantage in manufacturing industries. A two-sector model shows the sector with large scale economies profiting more than the other from a well-developed financial sector. In countries with higher levels of financial development, manufactured exports represent a higher share of GDP and of merchandise exports - and those countries have a higher trade balance in manufactured goods. Beck explores a possible link between financial development and trade in manufactures. His theoretical model focuses on the role of financial intermediaries in facilitating large-scale, high-return projects. Results show that economies with better developed financial sectors have a comparative advantage in manufacturing industries. He provides evidence for this hypothesis, first proposed by Kletzer and Bardhan (1987), using a 30-year panel of data for 65 countries. Controlling for country-specific effects and possible reverse causality, he shows that financial development exerts a large causal impact on the level of both exports and the trade balance of manufactured goods. (Thorsten Beck, World Bank)

Peter Isard's recent book (*Globalization and the International Financial System: What's wrong and what can be done?* Cambridge University Press, 2005) provides a thoughtful and balanced review of the scholarly literature on the past operation and potential reform of the international monetary and financial system. He provides perspectives on various aspects of the international financial system that contribute to financial crises and growth failures, and discusses the remedies that economists have proposed for addressing the underlying problems. It also sheds light on a central feature of the international financial system that remains mysterious to many economists and most non-economists: The International Monetary Fund and the factors that influence its effectiveness.

He describes and evaluates the literature on exchange rate economics. It provides a wide-ranging survey, with background on the history of international monetary regimes

and the institutional characteristics of foreign exchange markets, an overview of the development of conceptual and empirical models of exchange rate behavior, and perspectives on the key issues that policymakers confront in deciding whether, and how, to try to stabilize exchange rates.

The author's approach, from which much can be learned, is to draw lessons from the history of exchange rates and capital flows and, especially, from the financial crises of the 1990s. But this retrospective focus is also revealing of what is new and different about our current international monetary and financial environment and in the ongoing debate surrounding the future of its steward, the International Monetary Fund.

Economic globalization has given rise to frequent and severe financial crises in emerging market economies. Other countries are also unsuccessful in their efforts to generate economic growth and reduce poverty. His book provides perspectives on various aspects of the international financial system that contribute to financial crises and growth failures, and discusses the remedies that economists have proposed for addressing the underlying problems. It also sheds light on a central feature of the international financial system that remains mysterious to many economists and most non-economists: the activities of the International Monetary Fund(IMF) and the factors that influence its effectiveness. Dr. Isard offers policy perspectives on what countries can do to reduce their vulnerabilities to financial crises and growth failures, and a number of general directions for systemic reform. The breadth of the agenda provides grounds for optimism that the international financial system can be strengthened considerably without revolutionary change.

- Demystifies the IMF and elaborates on the factors that influence its effectiveness.
- Accessibly surveys the literature on the causes of international financial crises and current thinking about crisis prevention and resolution.
- Summarizes the factors that can stimulate or impede economic growth and poverty reduction, using no math.

Peter Isard brings deep scholarship and experience to the bewildering array of problems surrounding the brave new world of globalized international finance. It evaluates the current international financial system and its history, and drawing sensible implications for national and global policy. Anyone interested in the ongoing debate on globalization - and in particular, on the changing role of the IMF in the system "Peter Isard provides a thoughtful and thorough review of the accomplishments and challenges of the international financial system and its principal multilateral institution - the International Monetary Fund - in an era of inevitable, rapid globalization. He blends crisp analysis with deep institutional knowledge to produce an insightful and valuable tour de force. His literature is a blend of economic analysis and front line experience with the mysterious world of international finance A serious read, it takes on two great problems of our times, recurrent financial crises and the failure of financial and economic development

and sets out what we do and do not know about these problems. The IMF is a prominent player in this game and Isard provides an even handed and thorough explanation of what it does and why. Globalization is much maligned but little understood. This book provides a concise and accessible path to understanding.” “... it is important ... there is a general sense that the international financial architecture needs serious reform ... Secondly, how do we deal with sovereign financial distress without running up against 'nationalist resistance' as well as extra-economic issues such as national security and political governance? Thirdly, given the global nature of the desired reforms, how will the new financial architecture deal with issues of accountability and representation, as whatever shape the reform takes has crucial implications for many people? Isard's thesis could be summarized thus: globalization, and in particular economic globalization, has speeded up large international capital flows with greater possibilities for financial crisis, to which the international system is prone because a host of things are wrong with the way the current international financial architecture is shaped ... Globalization and its consequences, not just for the financial system, but also for areas such as energy, the environment, migration, public health, etc. will be issues for debate for some time to come and rightly so.”

Although economic theory and empirical investigations have much to say about where international capital may flow, both the theory and the evidence are less definitive about the impact of such flows. Once in a country, private capital may increase either domestic consumption or investment, or it may principally increase the country's foreign exchange reserves. If flows are driven merely by incentives to evade taxes or jump other legal barriers, money may flow out of a country as quickly as it flows in.

Despite these ambiguities, private capital flows are generally found to have a significant impact on domestic investment, with the relationship being strongest for foreign direct investment and international bank lending and weaker for portfolio flows (Bosworth and Collins, 1999). When a country is poor and saves little, additional capital from outside the country can help it realize investment opportunities.

The evidence is firmer on the conditions under which productivity benefits accrue, and the clear implication is that the productivity benefits are greater in countries with a skilled workforce and well-developed physical infrastructure. For example, studies show that in Malaysia, Taiwan, and the southeastern provinces of China, foreign direct investment boosts productivity. In contrast, studies on Morocco, Tunisia, and Uruguay do not find similar benefits. Indeed, there is some evidence that, following the entry of foreign firms, domestic firms do not gain "spillover" benefits from the knowledge that may accompany the newly arrived firms. Instead, they lose market share, and the consequent contraction lowers their productivity (Aitken and Harrison, 1999). Within countries, firms with greater research and development capabilities are better able to absorb the benefits that result from the presence of foreign firms. These microeconomic studies are supported by the cross-country regression findings of Borensztein, De

Gregorio, and Lee (1998), who determine that foreign direct investment is more productive in countries with a better-educated labor force. In a recent review of the literature, Eichengreen also finds that studies support the hypothesis that private capital flows are more efficient in higher-income countries. Similarly, the evidence suggests that private capital flows- especially portfolio flows- have been associated with the development of domestic capital markets, which, in turn, bolster growth. However, private capital flows can increase the vulnerability of a country with weak financial markets to banking and exchange rate crises.

The hue and cry of some of the developed economies about the fears of globalization leading to unemployment and movement of factors of production to the developing regions of the world from their home base, has been duly countered by Jagdish Bhagwati at the OECD forum 2005 on Fuelling the Future. At the discussion on Globalization, Outsourcing and Structural Adjustment, Bhagwati outlined the figures of the jobs lost in United States as a result of outsourcing factor only, which is about 200,000 a year. These are primarily low-value services and a tiny proportion of the total labor market turnover. He further says that the fears arise from looking at only one side of the equation and one must learn to induce flexibility and cope with newer challenges (OECD, 2005). "As we move forward, we all have learned the durable lessons about the benefits of fostering and preserving a flexible economy through an environment of maximum competition and consumer orientation. Fundamentally speaking, an environment of a greater economic stability has been the key to an impressive growth in the standards of living and economic welfare, which is so evident in much of the competitive market driven world."

Given the level of economic development, capital flow movements, exchange rate fluctuations, opening up of current and capital accounts by countries, emergence of crisis and the re-emergence of stronger financial systems in the last three decades, it is not clear whether there is reduction or increase in the extent to which international trade of the world economy is adversely affected or benefited by the fluctuations in the exchange rates (Clark, Tamirisa, Wei, Sadikov, Zeng, 2004).

A number of studies such as Speidell and Sappenfield (1992) and Ferson and Harvey (1994) suggest that global allocation strategies, consisting of choosing cross-border market combinations that are mean-variance efficient, resulting in increased linkages between world equity markets. India is slowly progressing towards achieving a similar state.

Several pre-crisis studies have shown that cross-market linkages are weak, which negates any justification to treat the Asian countries as a block in a mean-variance maximization objective. For instance, the study of Eun and Shim (1989) finds weak linkages between Hong Kong and Japan by using variance decomposition and impulse response functions using a Vector Auto Regression model (VAR) to assess the strength

and innovations from one market to the others from December 1979 to December 1985.

The September 11, 2001 terrorist attack, the recent financial scandals in the U.S., the Afghan air strikes, the sharp increase in oil prices and the U.S. intervention in Iraq in 2003 have serious economic effects on the world economy. These have led to tremendous flows of capital and increase in volatility of international financial market. This in turn generates the need for a collaborative effort to stabilize economic growth and development in the global village. The growing international linkage through Foreign Direct Investments (FDI) is an important move in the financial globalization and stabilizing need. With the integration of international capital markets, world FDI flows have grown strongly since the 1990s at a rate much above the global economic trade. Recorded global inflows have grown by an average of 13 per cent (over 1990-97) and 50 per cent (during 1998-2000), driven by large cross-border mergers and acquisitions (Patterson, Montanjes, Motala and Cardillo, 2004).

Supporters of FDI contend that foreign investors introduce a package of highly productive resources into the host economy, including production and process technology, managerial expertise, accounting and auditing standards, and knowledge of international markets. The challenge for the host economy is to benefit from the Multinational Enterprises (MNE)¹ presence, and to appropriate some of the increased income accruing from the resultant productivity growth. The large literature on FDI impacts concludes that the host economy benefits are quite uneven, both across and within countries. This suggests that host country policies are an important factor in the distribution of these benefits. Of particular relevance here, are the commercial environment, institutional quality, and supply-side capacities.

Both the aggregate and case study approaches usually, though not always, point in the same direction. In the case of Thailand, Archanun (2003) found that spillovers from foreign- to domestically owned firms in manufacturing industries were significant. He also concluded that they were more likely to occur in less protected sectors, both because these sectors are more attractive to MNEs and because of the presumed competitive spur of lower protection.

A number of studies have been undertaken to determine whether FDI impacts positively on economic growth. Two types of studies-macro and micro-have generally been conducted to study the relationship between FDI and growth. Micro studies usually find no positive evidence that FDI makes a positive contribution to growth. Macro studies, on the other hand, often find FDI to positively affect economic growth under certain conditions.

¹ Or Multinational Corporations(MNCs)

Balasubramanyam et al. (1996) test the hypothesis that export-promoting (EP) countries enjoy greater efficiency from FDI using a production function in which FDI is considered an additional input to domestic capital and labor. They argue that, since it is a prime source of human capital and new technology for developing countries, the FDI variable captures the externalities, learning by watching, and spillover effects. Exports are also used as an additional factor input into the production function, following the large number of empirical studies that investigate the export-led growth hypothesis. The model they use has real GDP dependent on labor, domestic capital stock, foreign capital stock, exports, and a time trend capturing technical progress.

Following Bhagwati's (1973) hypothesis, in which an EP strategy is likely to attract higher levels of FDI and promote its efficient utilization more than an import-substituting (IS) strategy, the FDI coefficient in the econometric model is expected to be positive and greater for EP countries than for IS countries. Also, for EP countries, it is expected that FDI is a more potent growth contributor than domestic investment because of the spillover effects and externalities associated with human capital, and the higher rate of technical innovation associated with FDI.

Their results for the entire sample of countries indicate that the impact of foreign capital on growth exceeds that of labor, which in turn exceeds that of exports. The parameter estimate for the impact of domestic capital is not significantly different from zero. Meanwhile, their results from the sub sample of EP and IS countries provide further support for the Bhagwati hypothesis. Their findings indicate that FDI is a positive and a significant contributor to growth for EP countries, while having no influence on growth for IS countries. In addition, as far as EP countries are concerned, it is FDI and not domestic investment that acts as a driving force in the growth process.

A later study by Balasubramanyam et al. (1999) tested four hypotheses of FDI's contribution to growth: (i) FDI can promote growth in the presence of a liberal trade regime; (ii) a threshold level of human endowment is necessary for the promotion of growth through FDI; (iii) effective utilization of human capital in conjunction with FDI requires an adequate domestic market for the goods produced; and (iv) technology and skill spillovers from FDI do not materialize from the mere presence of FDI, but from a competitive environment.

Their first hypothesis is the same as the one they tested in 1996. While the authors used the ratio of imports to GDP to determine whether a country is EP or IS in their 1996 study, they used the residual approach, calculating the deviation between actual and predicted export volumes, to measure trade policy orientation in their 1999 study. Classifying countries according to this method yielded the same results as their 1996 study. To test their second hypothesis, the authors included an FDI-human capital interaction term in their model, but found the coefficient to be statistically insignificant. In testing their third hypothesis, the authors used per capita GDP as a proxy for the role of the domestic market. While the coefficient of this variable turned out to be

statistically significant, its sign was negative. The authors explained that the variable may be picking up the dominance of convergence effects observed in endogenous growth literature. In addition, the coefficient of the FDI-human capital interaction term became statistically significant with the inclusion of the domestic market proxy. Finally, the authors tested their fourth hypothesis by including the share of manufacturing to total value added as a proxy for local competition, but the coefficient of this variable turned out to be insignificant.

Another study, by Borensztein et al. (1998) tested the effect of FDI on economic growth in a cross-country regression framework. They used data on FDI received by developing countries from industrial countries only. The results suggest that FDI is an important vehicle for the transfer of technology, contributing more to growth than domestic investment. There were also indications that FDI has a positive effect on economic growth, but this impact was dependent on the human capital stock in the host economy. The higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies that it brings is available in the host economy.

The authors also found some evidence of a crowding-in effect, i.e., that FDI are complementary to domestic investment. A one dollar increase in FDI inflows is associated with an increase in total investment in the host economy of more than one dollar. This implies that FDI exerts a positive effect on domestic investment, ranging from 1.5 to 2.3, probably due to the attraction of complementary activities that dominate the displacement of domestic competitors. Most of the effect of FDI on growth likely derives from efficiency gains rather than an overall higher induced level of investment.

More recent studies, however, assert that the results of such macro studies are flawed. Nair-Reichert and Weinhold (2001) argue that traditional panel and time series estimators often impose homogeneity assumptions across countries in studies of the relationship between FDI and growth. Their findings, meanwhile, show strong evidence of considerable heterogeneity across countries. This indicates that incorrectly imposing the homogeneity assumption on the data can lead to biased estimates and faulty policy implications. To circumvent the problem, the authors use mixed, fixed, and random (MFR) panel data estimation to test for causality between FDI and economic growth in developing countries. Results from the MFR estimation differ substantially from traditional panel data causality results. While traditional tests suggest a significant and uniform impact on growth from FDI, this study finds the causal relationship between investment (foreign and domestic) and economic growth in developing countries to be highly heterogeneous. While domestic investment seems to be strongly correlated contemporaneously with growth, it is not generally a strong causal determinant of future growth. In addition, the study finds a causal relationship from FDI to growth and there is some evidence that the efficacy of FDI is greater in more open economies,

although this relationship is highly heterogeneous across countries. The study also finds no statistically significant role for human capital in economic growth, but this does not mean that human capital is unimportant, since the relationship between human capital and growth is quite complex and may not be adequately captured in linear models.

Carkovic and Levine (2002) also dispute the generally positive findings on the FDI-growth relationship. They argue that the many macroeconomic studies that find a positive link between FDI and growth do not fully control for endogeneity, country-specific effects, and inclusion of lagged dependent variables in growth regressions. After controlling for these statistical problems, the authors find that FDI inflows do not exert an independent influence on economic growth.

The studies mentioned above illustrate the ongoing controversy regarding the importance of FDI on economic growth. While an exhaustive literature has already emerged to support each side of the debate, closure remains elusive.

B. Research

Chapter 1 The Structure of International Finance, Structure of International Trade/Multilateral Trading System; and its interface with World Investment, International Trade and Global Economic Development

Introduction

The gap among developed, developing and least developing countries largely comes down to the financial and physical assets that create wealth. Developed economies possess more of this capital than developing and least developing ones, and what they have usually incorporates more advanced technologies. The implication is clear: A key aspect of economic advancement lies in poorer nations' capacity to acquire more capital and scale the technological ladder. Emerging economies undertake some capital formation on their own, but in this era of globalization, they increasingly rely on foreign capital. At an early stage of development in most of developing and least developing countries domestic savings are often not sufficient to finance the investment needed to achieve capital accumulation and faster economic growth. Robust global growth and favorable financing environment provided the context for a record expansion of private capital flows to developing countries in 2005 and 2006.

Foreign financing may be expected bring higher rates of investment, which machinery and technology responsible to productivity growth needs to be imported from abroad. Foreign financing is, however, only one of a host of factors that influence the rate of

economic growth. The reallocation of resources through international flow of capital has been by far constructive towards building a more integrated and cost efficient economic system. This has been observed to be a natural byproduct of the increasing inter-dependence of national economies. The inter-dependence has been heightened in the process of globalization and liberalization

Globalizations of the late 1990s and early 2000s have witnessed a tremendous flow of international trade, capital, and services. Most of the record US\$ 491 billion in net private capital bound for the developing world in 2005 went to a small group of middle-income countries. Many of those countries took advantage of the growing inflows to improve their external debt profiles and accumulate large holdings of official foreign exchange reserves. (Global Development Finance: The Development Potential of Surging Capital Flows 2006: Review, analysis and outlook)

Moreover, as incomes of these countries rise, the demand for imported consumer goods and raw materials tends to rise, leading to a higher trade deficit, which needs to be financed from abroad. Thus, for example, the East Asian economies, despite their reliance on export-led growth, and the fact that they have had a high level of domestic savings, found themselves with large foreign financing requirements during the 1970s, 1980s and 1990s.

Currently several developing countries have emerged as an integrated global economic force having re-organized production process with changes in nature and location of development and finance. The tremendous improvement in the economic and investment scenarios in some of the hard hit economies of the 1990s like Argentina, ASEAN tigers, Russia, Turkey have re-emerged out of crisis. Also the trends have been very encouraging for other economies which played a small role in international trade till the mid-1990s like India and China towards an equitable economic growth and social prosperity. This has been a clear indication of interface of global finance, international trade and investment.

Interface of international finance, trade and investment presents before a number of intriguing anomalies, but the one that seems to bedevil policy makers is the desire to seek stability, financial development and equitable socio-economic growth. Some of the interesting cases in the last decade which have shown substantial development and correction in their macro-economic factors in the developing region have been India, Israel, China, Argentina, Turkey despite Tsunami, Oil price rise, steep increase in US current account deficits, a non-stable weaker US dollar, troubled pension funds and unemployment on a rise in large part of the developed region. Given the level of advancement in information, communications, trade and capital flows, there has been tremendous innovation and improvement in the world productivity. This has been possible at the back drop of reduced transaction costs and easy access to global resources.

International linkages and benefits arising from interface of international finance, trade and investment sometimes are expected to be inversely related, in that higher correlations between markets are less effective in decreasing portfolio variance. Markets are said to be in long-term equilibrium when long-term expectations in one can be used to predict long-term movements in another market. The markets are then said to be co-integrated. Hence the spillover effects can be observed in co-integrated markets. International portfolio managers are hence concerned with linkages in the short and the long run. It is clear, however, that the challenges of globalization today; the resultant volatility in the international financial markets; emergence of e-finance and capital flows; the rise in productivity and the role of government and regulatory bodies cannot be adequately handled by a system that was largely designed for the world 50 years ago. Changes in international economic governance have to keep pace with the growth of international interdependence. The role of the IMF, the World Bank, the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD) and other international agencies and the central banks demands them to be more alert and develop means to face the challenges of a dynamic changing financial scenario interlocking trade and transfers.

International Financial Structure

Capital Flow involves international capital movement mainly through three important ways:

1. Private Capital Flows

- Portfolio equity investment, which involves buying company shares, usually through stock markets, without gaining effective control.
- Foreign direct investment (FDI), which involves forging long-term relationships with enterprises in foreign countries.

2. Portfolio Debt Investment

- Concessional flows cover borrowing from multinational institutions, such as the World Bank and others.
- Private Portfolio debt investment covers bonds and short- and long-term borrowing from banks and financial institutions.

3. Foreign Quasi-Equity Investments

1. Private Capital flows

The recent rise of private capital flows has fundamentally changed the conventional notion of foreign finance filling a given resource gap. 2005 was a landmark year in global development finance, in both the official and private spheres. The increase in private flows in 2005 was broad-based, with long term bond issuance, bank lending, and portfolio equity showing strong gains. The strong gains in private capital flows have been supported by financial innovations, notably local currency and structured financial instruments, such as credit default swaps and other derivatives, which have improved the ability of investors to manage their exposure to the risks associated with emerging market assets.

A large part of these recent inflows has been motivated by the actual, perceived, or expected relative macroeconomic conditions of countries, namely, differences in interest rates and expectations concerning future inflation and movements of exchange rates across different countries. Such flows are not expressly in response to developing countries' needs.

While, as part of foreign capital inflows into developing countries, they would in principle seem to contribute to capital accumulation, they may easily cause major changes in macroeconomic balances which frustrate domestic policy and targets for economic growth, inflation, and employment. Not too, they create serious financial difficulties for the country concerned. To discern the development impact of foreign private flows, it is necessary to consider the different components of such flows separately.

Foreign Portfolio Investment in Equities

Developed country institutional investors (pension funds, insurance companies, and mutual funds) have over the years become key actors in the world's capital markets. The assets of mutual funds, which have become the most popular means for portfolio investment by relatively small investors, have risen at the expense of commercial bank deposits for almost two decades. Like FDI, foreign portfolio investment in equity entitles the investor to a share in the profits of a private enterprise. Unlike the direct investor, however, the equity investor typically seeks only a share of profits and appreciation of capital in the stock market, and is not interested either in ownership or management of the company, and so it does share the responsibilities and risk of business. Indeed, many equity investors deliberately restrict their holdings to a small percentage of the total stock in order to maintain liquidity and avoid being forced to take responsibility. Portfolio equity investment involves varying degrees of penetration of the domestic economy. The least penetrating mode, popular in many developing countries, is the offshore investment trust that is invested in a broadly diversified portfolio of domestic shares. Other more penetrating modes involve investments in individual shares; either

through offshore listings of developing country firms or purchases of locally listed shares.

In 2005, some 15 per cent of their portfolios consisted of overseas investments, mostly high grade bonds and foreign currencies. During the 2000s large institutional investors became prominent purchasers of equities in a few developing countries, which came to be referred to as the emerging markets, in search of higher and quick returns and to diversify their portfolios.

An important factor that increased the supply of funds for overseas portfolio investment was the liberalization of capital markets in industrial countries. All industrial countries had removed exchange controls by the end of the 1980s and moved towards complete capital account convertibility only in the 1970s and 1980s. France and Italy introduced capital account convertibility only in 1990. Changes in government regulations and in the provision of tax benefits encouraged increases in pension fund contributions by both individuals and companies.

The decline in interest rates in the industrial countries was another major factor contributing to the rise in the supply of funds for portfolio investment. Interest rates in the United States have been at a thirty-year low, in Germany, they have been lowest since the war, while in Japan, such low rates have not been witnessed over the past century.

Portfolio diversification through investment in developing countries appeared particularly attractive because the available evidence suggested that while stock markets of the industrial countries tended to rise or fall together, no such relationship seemed to exist with respect to the movements in developing country markets, a reflection of the fact that there were few portfolio investments by outside investors.

Nevertheless, portfolio investment in developing countries was still considered marginal and relatively risky and it accounted for only a modest share (perhaps, 1 or 2 per cent) of the assets of institutional investors. The recent financial and economic crisis affecting East Asian countries and the contagion effect showed the high potential of portfolio investment and currency speculation to wreak havoc upon the economies of recipient developing countries. Emerging markets as a whole are currently considered overly risky by overseas portfolio investors.

Inflows of such capital may help finance a current account deficit, but there is no assurance that they will contribute to physical capital accumulation. The highly volatile nature of these short term investments presents serious problems for maintaining economic stability in developing economies, creating particular problems for the balance of payments and exchange rate stability.

The volatility is largely rooted in the herd-like behavior of investors, which became more pronounced as northern pension and investment funds began to invest abroad, including in some developing countries. Moreover, the "contagion effect", whereby what investors do in one market often affects what investors do in another, means that there may be serious widespread international ramifications of events in one single country.

Policies of financial liberalization which permit or encourage inflows of short term capital also create conditions in which hedging operations and other speculative currency transactions give rise to exchange rate instability and currency depreciation with disastrous economic consequences. Even in more normal times, financial markets are able to exercise a sort of conditionality or veto over government policy and choices, with potentially serious social, economic and political consequences.

A series of financial crises over the last two decades, emanating from problems associated with private flows, have seriously hampered the process of economic development. Indeed, especially of late, it almost seems that the developing world has just been moving from one crisis to the next.

Fund flows to the emerging markets, according to experts. The Institute of International Finance expects that after reaching a 11-year high of US\$38 billion in 2004, emerging market portfolio (equity) investment declined to a fraction in 2005 to US\$37 billion.

The Asia/Pacific region is expected to account for over 90 per cent of total equity portfolio flows to emerging market.

In China net inflows was anticipated to increase in 2005 to US\$15 billion from US\$12 billion in 2004. Latin America a net outflow of portfolio equity investment was US\$4 billion in 2005, following an outflow of US\$7 billion in 2004. Chile will account for the bulk of outflows.

Foreign Direct Investment

Recent years have witnessed a growing enthusiasm in developing countries for FDI as a means of raising the level of capital accumulation and achieving development objectives including, for example, speeding up the rate of technological change.

However, in their concern to derive the important benefits to be gained from FDI, there has been a tendency among developing countries to underestimate or overlook the potentially significant costs associated with an inappropriate level and kind of FDI.

Thus, while FDI, either through purchase or the establishment of new production facilities ("green field" investment), may contribute to capital formation and to export earnings, its wider contribution to technological change and growth of the economy may be limited if, for example, the FDI is virtually an enclave activity and not well integrated into the rest of the economy.

In particular, insufficient attention has been paid to the potentially serious implications which FDI may have for the balance of payments, currency markets and macro-economic policy, and even the longer run financial viability of the economy.

For FDI to make a positive long term contribution to the economy of developing countries, efforts should be undertaken to ensure that the economy generates a sufficient export surplus to be able to cope with both the additional import demands generated by FDI and the repatriation of FDI profits. The absence of such could pose serious problems on the foreign exchange – and negate the purposes for which the FDI was in the first instance admitted to the country.

Flows of FDI can also be quite volatile, and their balance of payments and macroeconomic effect therefore need to be taken into account. Previously FDI was largely characterized by the fact that it involved a purchase of fixed assets and was long-term in intent, whereas portfolio investment flows were always known for their volatility. Now, with the introduction of financial liberalization and foreign exchange markets, those involved in FDI are able to liquidate their investments rapidly by borrowing funds on the local market, to buy foreign exchange and take capital out of the country as they choose. Other financial activities associated with FDI, such as currency hedging operations, also add to the volatility of financial flows. Volatility aside, FDI flows may act in a pro-cyclical manner. Either of these patterns of behavior can cause serious problems for macroeconomic management.

From the point of view of macro-economic stability and development, therefore, the level and type of FDI are of considerable importance and FDI has to be managed in the same way as other debt creating flows.

Other problems associated with FDI can be seen by considering, for example, such investment in the context of the privatization of public facilities and enterprises in developing countries. The change in the ownership of assets may provide a short term inflow of foreign exchange revenues to the immediate benefit of the public finances. But the transaction does not necessarily generate any short term improvements in technology and management to raise productivity or lead to an expansion of capacity. Nor, in most cases, will it generate new export earnings. It will, however, give rise to a permanent stream of profit remittances abroad, assuming that profits are actually made. Often, too, the developing country government provides guarantees to the enterprise so that, in the event of failure, the government is responsible for servicing

the debt or compensating the investors. For the maximum benefits to be derived there is need for careful negotiations and an appropriate regulatory framework.

There are, in addition, other potentially problematical aspects of FDI, including the impact on the competitive environment resulting from investment by large multinational corporations which may exercise considerable market power. Moreover, in an increasingly open and more competitive world economy, there is the possibility that a local company's assets are acquired by a foreign investor with a view to downsizing or even closing down the enterprise, as part of the new owner's global corporate strategy. In addition to economic interests, less tangible but no less important political issues may be at stake, as, for example, when foreign investment comprises a large proportion of total investment and involves a loss of national control over strategic sectors of the economy, vital infrastructure or natural resources.

Considerations such as the foregoing have given rise to widespread concern among developing countries at the prospect of a multilateral investment agreement being pressed for by the North to provide for almost unfettered flows of FDI. What, in effect, would become a global regime extending the right for foreign investors to invest as and how they wished anywhere in the world, and with no attendant responsibilities on their part, cannot be acceptable to developing countries. Such a regime would prevent developing countries from deciding what each considers being an appropriate level of FDI and what types of foreign investment they wish to encourage, thereby undermining the management of FDI flows which is essential to good macroeconomic management.

This is the traditional alternative to sovereign borrowing and entitles the investor to a share of the distributed profits of a firm. The parent firm is typically motivated by the return it expects to earn by making use of its existing know-how in a local operation and/or by incorporating the local operation in its global production and marketing network. FDI facilitates global integration, industrial diversification, privatization, infrastructure development, technology upgradation, and acts as an engine of external trade and overall growth.

Unlike other capital flows, FDI is a package that embodies capital along with technology and managerial, marketing and technical skills. Presence of multinationals promotes greater efficiency and dynamism in the domestic sector and widens external trade. Training gained by local employees and their exposure to modern organizational system and international best practices are valuable assets for the host country

2. Portfolio Debt Investment

Concessional flows

Official concessional flows originated as part of the efforts to rebuild Europe in the wake of World War II and were subsequently extended to developing countries. The rationale for concessional finance for the purposes of economic development was fairly straightforward. It was recognized that poor countries had only a limited debt-servicing capacity, which meant that borrowing from commercial sources could play only a relatively minor role in financing development, at least in the early stages. Private lending, because of its generally short-term horizon, was also held to be unsuitable for financing projects with long gestation periods, such as infrastructure projects, which were the focus of reconstruction and development efforts at the time.

Net official flows of grants and loans continued to fall in 2005- for the fourth consecutive year. Net official lending came to –US\$71.4 billion in 2005, the third consecutive year of net outflows from developing countries. In three years, developing countries have repaid US\$112 billion in loans to creditors. In contrast, aid (comprised of concessional loans and grants) has increased significantly during this period, particularly for low-income countries.

The dramatic decline in net official lending over the past few years reflects, for the most part, large repayments to the International Monetary Fund (IMF) and large prepayments to bilateral official creditors. In 2005, net debt *out-flows* from developing countries to the IMF totaled US\$41.1 billion, down from a net debt *inflow* of US\$19.5 billion in 2001, implying a –US\$60.6 billion swing in net lending by the IMF over the period 2001–5. The sharp decline is due to large repayments on emergency assistance loans made to Indonesia and the Russian Federation in 1997/8, and to Argentina, Brazil, and Turkey in 2001/2. The sharp decline in 2005 reflects large repayments by Argentina (US\$2.4 billion), Brazil (US\$16.8 billion), Indonesia (US\$1.0 billion), the Russian Federation (US\$2.3 billion), and Turkey (US\$4.2 billion). Moreover, gross lending by the IMF has declined from about US\$30 billion in 2002–3 to only US\$4 billion in 2005. This reflects the marked improvement in international financial stability, supported by the favorable global economic and financial conditions. (Global Development Finance: The Development Potential of Surging Capital Flows 2006: Review, analysis and outlook)

Alternative Modes of Debt Investment

There has been a significant change in the traditional structure of international capital flows to the developing countries over the years. Until the middle of 1980s, bank lending was the major mode of foreign private/official flow to the developing countries. Subsequently, the relative importance of bank lending has declined and that of other

modes has increased. The share of foreign direct investment (FDI) has increased the most followed by bond lending and foreign portfolio investment.

The major alternatives to syndicated bank lending are discussed below:

Bond Lending

This type of lending has flourished in recent years. International bond markets have two components: Eurobond and foreign bond markets. Eurobonds are underwritten by an international group of banks and are issued in several different national markets simultaneously. They are not subject to formal controls. Foreign bond markets are simply domestic bond markets to which foreign borrowers are permitted to access.

Financing Through New Instruments

In recent years a plethora of new instruments and modes has emerged in the international financial system. Most of these are hybrid instruments between bonds and bank lending. Some seek to achieve continued access to bank lending (such as note-issuance facilities and transferable loan instruments), and others seek to expand the use of international capital markets (such as floating rate notes). New modalities for conducting international financial intermediation (such as interest and exchange rate swaps and options and networks such as CHIPS and GLOBEX) have also emerged.

3. Foreign Quasi-Equity Investments

A foreign quasi-equity investment opens the package of a risk-sharing and managerial control. These new forms of inter-national investment include joint ventures, licensing agreements, franchising, management contracts, turnkey contracts, production sharing and international subcontracting. While bond lending and lending through new instruments together with syndicated bank lending are forms of general obligation finance in the sense that the lender provides money to be repaid on terms independent of the success of investment made with the funds, financing by other alternatives (i.e., FDI, foreign portfolio investment and foreign quasi-equity investment) involves risk-sharing and responsibility sharing. For example, under FDI an investor is entitled to a share of the distributed profits of a firm and an investor also shares in the responsibility of managing the firm. Portfolio investment is similar, except that it does not encompass sharing management responsibility.

Using criteria developed by Lessard (1989), the five alternatives to bank lending can be assessed in terms of expected cost, degree of risk-sharing and degree of managerial participation in the project (**Table-1**). The major advantages of foreign direct

investment, foreign portfolio investment and foreign quasi-equity investment are that they involve risk sharing, sharing of managerial responsibilities and the promotion of a more efficient use of resources. Foreign portfolio investment, in addition, has a favorable impact on local capital markets. The disadvantages are that there might be misuse of control and that foreign direct investment might introduce inappropriate technology.

Table-1: Alternatives to Bank Lending

Modes of capital transfer (1)	Expected Cost (2)	Risk-sharing (3)	Management Sharing (4)
1. Bank lending	High	Low	Low
2. Bond Lending	Medium	Low	Low
3. Market derivatives	Medium	Medium	Low
4. Foreign Direct Investment	High	High	High
5. Foreign Portfolio Equity	Medium	Low	Low
6. Quasi-Equity Investment	Medium	High	Medium

If developing countries are to seek external financial flows to augment and complement what can be mobilized through their domestic savings, it is essential- therefore- that there be a clear understanding of the impact that different types of capital inflows can have on their economies, both at the macro- and the microeconomic level.

Structure of International Trade

International trade has been expanding as a share of world GDP ever since the end of World War II. The mid-1990s has witnessed the rapid expansion in terms of both imports and exports of individual countries. Over the past decade there has been an expansion of trade with emergence of an active role played by developing economies like India, China, Brazil and others coupled with the large US trade and current account deficits, the emergence of euro and the correction in the over priced US Dollar. With the benefits from trade being observed by the developing region, the developing economies have fueled the creation of factors for enhancing growth. This enrichment of factors of growth has been by extensively investing in improvement of infrastructure, creation of more flexible but sound financing systems, developing market-driven economic systems, deepening of financial markets, so as to achieve desired economic goals with equitable contribution to pre-existing social-economic frameworks.

The geography of world trade has also changed. From a largely inter- developed country and inter developed and developing country focus, trade between developing countries- or what is often referred to as South- South trade has gained increasing prominence in more recent years.

Worldwide, merchandise exports grew by 22.5 per cent in current dollars in 2004, partly due to increasing volume and partly to rising dollar prices, e.g. for oil and other commodities but merchandise trade growth slowed somewhat in 2005, expanding by 8.9 per cent, as compared with 11.8 per cent in 2004 . Major contributors to this growth were the increased trade between China and the US and the recovery of international trade in AEAN and Asian NIEs (newly industrializing economies) As for developing countries, they now account for about a third of global trade, and some 40 per cent of all their trade is between themselves. Developing countries export volumes increased to 10.3 per cent in 2005, only some-what slower than the year before This South-South trade is also growing about three times faster than world trade. China and India, of course, are garnering a large share of this rise in trade, accompanied by soaring GDP. China's average export growth rate rose fairly steadily - barring a few blips - from 12.8 per cent in 1980-90 to 31 per cent in 2003-04. China's export volume expanded by 27.8 per cent in 2005, almost exactly as fast as in 2004.

In the same period its GDP has stayed largely on a growth course, climbing from 7.5 per cent in 1980-90 to 9.5 percent in 2003-04. The Indian figures follow much the same pattern. Global integration is likely to enter a new phase. In virtually every growing economy the importance of trade- captured by the ratio of trade to GDP- will rise, continuing the trend of the past two decades. The growth in the trade ratio over the next 25 years will be powered by a new dynamism in services trade. Global trade in goods and services, growing faster than out-put, is likely to rise more than threefold to US\$27 trillion in 2030. Approximately half of this increase will come from developing countries. This means that a growing share of global production of goods and services will be performed in those developing countries able to take advantage of new opportunities.

The ascent has been accompanied by the global interdependent, brighter outlook for exporters of primary commodities, rising trade amongst developing countries and increasing exports of capital from the developing to the developed countries (UNCTAD TDR, 2005). Despite the increase in importance of the fast growing developing regions of the world, the developed world still accounts for the two third of the global non-fuel commodity imports in the international commodity markets. The move towards the adoption of more outward-oriented development strategies along with creation of domestic demand, trade reforms and regional trade agreements have widened the range of developing countries significantly in the global markets

The low cost efficient systems, products, services and finance is turning out to be a challenge for the developed countries. The influx of cheaper high quality goods and services from developing countries is seen as a threat to domestic industry by most of the developed countries. This is the same challenge with which the developing world was faced at the time of opening up of their markets in the early 1980s and 1990s. Some have adapted by increasing import duties, barring commodities on the pretext of dumping and discouragement of movement of factors of production into other cost

effective regions. National competitiveness has become one of the prime concerns for almost all in the developed region. Arguments that the exchange rate has been artificially set to enhance the competitiveness of exports (US/ China trade) have become more pronounced. Taking all of this into consideration, it is pertinent to note that the real gains from international trade is contingent upon factors such as the structure- and mix – of a country's exports and its international competitiveness – which in itself is contingent upon other factors such as the availability of well-trained human resources and the cost of doing business in the country.

The benefits derived from international trade are however not equitably shared by all developing countries. Much of it is concentrated in a handful of countries, with many others becoming increasingly marginalized. Merchandise exports of sub-Saharan Africa, for example, have declined as a percentage of world exports, from 1.6 per cent in 1990 to 1.35 per cent in 2004. The share of the world's 50 poorest countries – the "least developed countries" (LDCs) - rose minimally over the same period, from 0.56 per cent to 0.64 per cent. If this is not bleak enough, it is worse in the case of trade in services. These figures are extremely alarming, given the intertwined evils of poverty, economic instability and terrorism.

The Multilateral Trading System

The expansion of trade has played a dynamic role in the growth of the global economy since World War II. But, until the Uruguay Round of trade negotiations began in 1986, multilateral trade deals tended to be limited to the industrial countries. While developing countries benefited significantly from the growth in global trade, they were rarely active participants in the bargaining process. Transition from the General Agreement on Tariffs and Trade (GATT) to the World Trade Organization (WTO) in 1995 constitutes one of the most important developments in the world economy of the twentieth century. The emerging WTO regime is important for the national development, trade, investment and technology policies of member countries.

A number of important issues remained unresolved, however. WTO trade negotiations to address the Uruguay Round's unfinished business were launched in Qatar in 2001. The so-called Doha Round- also known as the Doha Development Agenda because of the high priority attached to developing country interests- encompasses manufacturing, agriculture, and services; calls for the tightening of trading rules and special provisions and assistance for developing countries; and addresses problems with the implementation of certain Uruguay Round commitments.

Various studies have pointed out that the main beneficiaries of trade liberalization have been the industrial countries primarily due to efficient, high quality and low cost products and services. The trends seem to observe a change lately in 2004 and 2005, with the emergence of the developing region which has induced efficiency, large

domestic demand, low costs and the facility to trade. To supplement the WTO, the developing countries have moved into the realm of bilateral trade and investment initiatives, such as Free Trade agreements (FTA) and Bilateral Investment Treaties (BIT) with other regions and other developing countries. This is a consequence of the failure at the Cancun WTO ministerial meeting - a major set back to the multilateral trade regime.

The geo-politics of world trade has changed with the entry of China into the WTO. The accession of China to the WTO and the consequent guarantee of Most Favored Nation (MFN)² status that it receives from other WTO Member countries has serious implications for the domestic national competitiveness of the developed country Members, let alone developing countries and Least Developed Countries (LDCs). It is clear, however, that global partnership brings forth the challenges for globalization today along with the changes in international economic governance, which has to keep pace with the growth of international interdependence.

Currently countries are having difficulty reaching agreements on key issues- particularly the dismantling of industrial country protection for agriculture. Agriculture has been so contentious that it has eclipsed trade in manufactures and services, two areas that are also important for many developing countries. The scope for industrial countries to strike mutually beneficial bargains with each other is shrinking. Attention in the WTO is increasingly shifting toward trade between industrial and large developing countries, as the latter use their relatively closed markets for services, capital, and manufacturing as bargaining chips in negotiating for greater access to industrial markets for agriculture and labor-intensive manufactures and services.

The stakes are different for the smaller, less developed countries. Under preferential agreements, many now enjoy virtually unimpeded access to certain industrial country markets. They are leery of multilateral trade liberalization because of concerns about adjustment costs, food security, and the loss of export markets to more competitive countries. They also fear that increasingly complex trading rules might be expensive to implement and therefore hamper their ability to pursue development policies. However, there is large untapped potential in more open trade *among* developing countries.

All countries would benefit from faster global growth as a result of continuing multilateral liberalization. Each country's own trade reforms can boost development. And the opportunities that greater integration offers over the longer term far outweigh the short-term costs- which, in any case, must not be overestimated.

² Most Favored Nation treatment (Article 1 of the GATT) requires that all goods imported into a country shall be treated in the same manner as that imported from all other WTO Members.

With appropriate assistance from the international institutions and donor countries, implementation and adjustment problems should be manageable.

International Finance and its interface with trade, investment and development

Strong financial systems are the key factor for proper financial developments. international financial markets have observed volatility of capital flows, which to a great extent is a contributing factor of the financial developments in the world economy. Financial developments have played a critical role in promoting industrialization in countries such as England by facilitating the mobilization of capital for large investments. Financial development contributes significantly to growth. Such developments are central to poverty reduction. Some of the researches have shown that financial development directly benefits the poorer segments of society and also income redistribution.

However, in the process of global integration of financial markets, the economies of developing countries have become highly vulnerable to speculative capital movements in and out of the country. The economic crisis in Mexico in 1994, more recently the currency crisis in the East and South East Asian countries in 1997, the Russian crisis in 1998, the Brazilian crisis of 1999 and the Argentinean crisis of 2001 have highlighted the role played by speculative capital movements and contagion effect in triggering-off the crisis situations. The financial crisis of July 1997 that has affected some of the best performing Asian economies has been a subject of intense concern. It has provoked rethinking, world over, on the risks and benefits that liberalization of financial and capital markets and the global integration has carved, especially for the developing countries. It has also highlighted the importance of the prudent regulation of the domestic financial and banking sectors. Finally, it has exposed some of the weaknesses of the existing approaches in handling the crises such as those enforced by the IMF. Given the increasingly interdependent nature of the world economy, the fortunes of all the countries are highly inter-linked.

The liberalization of capital flows in the last 30 years and the enormous increase in the scale and variety of cross-border flows, barring the difference of developing or developed economies, has clearly increased the magnitude of exchange rate movements. A high level of buoyancy has been observed especially in the newly emerged capital markets of not so stable/mature economies. The last two decades have been a clear witness of the currency crisis in the emerging markets as a result of bulk movement of capital flows and exchange rate volatilities. Fortunately, the presence of hedging instruments and risk transfer mechanisms in the last two decades in almost all financial markets have emerged to mitigate the negative effects of these volatilities. Given the level of economic development, capital flow movements, exchange rate fluctuations, opening up of current and capital accounts by countries, emergence of crisis and the re-emergence of stronger financial systems in the last three decades, it is

not exactly clear whether there is a reduction or increase in the extent to which international trade or the world economy has been adversely affected or benefited by the fluctuations in the exchange rates. The important question is how volatile is the volatility, as more markets and institutions have developed the means to sustain and nullify the sensitivity of exchange rate risk and mitigate other risk costs with the given hedging tools in domestic and offshore markets. One important point however bears out: a stable exchange rate system is a precondition for sustained growth in international trade and for the world economy.

Certainly the financial world is a more stable system with most economies moving towards a market driven economic system and the acceptability of other currencies (Euro), than the US\$ as a reserve or international currencies for both trade and finance (including exchange rate determination).

The world economy at the turn of the century has influenced the process of globalization, global partnership and capital flows as a portfolio of global socio-economic enrichment. The re-allocation of good and services without the movement of labor; emergence of developing countries like India and China as exporters of good and services and also as a provider of the largest consumer base for world trade; the weakening of the dollar and improvement of terms of trade have been some of the remarkable trends in world investment. World output growth has grown from an average of 2.7 per cent (1990-00) to 3.8 per cent in (2000-05) despite the severe depressive phase in 2001 (1.3 per cent) and 2002 (1.8 per cent), at the sluggishness in the US and Germany. World growth to a large extent has been fueled by the developing region which has grown at an average rate of 5.5 per cent (2000-05).

The services sector – largely overlooked as another major source of growth – has also the potential to serve as the twin engine of growth. In the early 1970s, the services sector accounted for only one-quarter of total world FDI stock; in the 1990s, this share changed to one-half and by 2002, it is over 60 per cent (about US\$ 4 trillion). On the other hand the proportion of the total world FDI stock for the primary sectors have declined from 9 per cent to 6 per cent and that of manufacturing fell even more from 42 per cent to 34per cent (UNCTAD-IIAS, 2005).

The growing international linkage through FDI is an important move in the financial globalization and stabilizing need. With the integration of international capital markets, world FDI flows have grown strongly since the 1990s at a rate much above the global economic trade. Recorded global inflows have grown by an average of 13 per cent (over 1990-97) and 50 per cent (during 1998-2000), driven by large cross-border mergers and acquisitions (Patterson, Montanjees, Motala and Cardillo, 2004).

There has been a substantial dip in the inflows at the beginning of the millennium due to events outlined earlier. Having seen the fruits of FDI verses portfolio flows, economies are focusing and framing their policies to attract more FDIs to foster

technology transfer, reduce un-employment, increase foreign participation, have risk transfer mechanism and cost effectiveness within their economic system. Given this, the job of the central banks is becoming harder day by day in trying to keep inflation and money supply under check

Development Nexus

Over the last three decades, the world economy has observed not only a quantitative leap in the volume and value of international trade and financial transactions but a qualitative transformation in the way different nations interact with each other. Today we have a more integrated and networked global economy, be it in terms of finance or factors of production or trade. The benefits of an efficient system with low cost and the need for enhancing purchasing power of the consumer has been a direct motive behind the economies to have opened up to a more liberal market driven economic system. While the opportunities offered by globalization are large, the question which ponders back and forth time and again is if the actual distribution of the gains is fair, in particular reference with the down-trodden benefiting for the process.

Policies of openness through liberalization have been advocated worldwide for the growth and welfare-enhancing effects on the basis of prominent theories on international trade and investment. Be it the Ricardian comparative advantage, the Heckscher-Ohlin-Samuelson model, Bhagwati or Krugman's view or any other, the common factors outlined are that the static efficient gains associated with improved resource allocation for national economies. (Nissanke & Thorbecke, 2005). The world is moving towards an increased specialization wanting to gain from economies of scales, diffusion of information, technology transfers and cross border movement of funds keeping risk diversification well in place. One of the critical reasons for globalization for not seemingly to have produced desired results in the low-income developing countries lies in the fact that the effects of international trade on growth are critically dependent on the pattern of specialization and integration. Countries that have created patterns of comparative advantage towards high-skill and high-productive activities have gained significantly. One however needs to have clear focus on investment in agriculture in order to reach takeoff-point to allow structural transformation, strengthening institutions for social protection and infrastructural smoothening.

To benefit from an increasingly globalized and inter-dependent world economy, countries need to strengthen their capabilities for the supply of competitively efficient and cost effective goods and services. In the process of liberalization in the last three decades, it has been believed that the developed region has been more open than the developing towards FDI flows, be it services or other factors of production (OECD, 2003). However, it has been observed that even liberal and mature economies such as the United States, France, Germany and many others, have restrictions on services.

Chapter 2 Integration of International Financial Markets & the Capital Flows: Emerging Issues and Trends

Integration of International Financial Markets

The evolution of flows of international capital can be linked in the context of the integration of the international financial system and of the global economy. Some of the key aspects of the evolution are as follows:-

Early Phase

The value of printed currency has always been of concern. The practice, before World War I, had been to link it to the sum of bullion held by the treasury (the so-called gold standard). Net exporting economies, accumulating foreign exchange (often as gold), would then find their currency value rising; those with deficits would undergo the opposite. Meanwhile, currency and trade were private sector prerogatives, with official treasuries making requisite adjustments in terms of money supply (or coinage).

World War I and the Great Depression (1929) changed this. The US and European economies began experiencing increases in variance across inflation rates. That led Gustav Cassel, an economist of that era, to assume that exchange rate changes should account for differences in inflation rates. To him, terms like undervaluation, or overvaluation were just a layman's way of saying that the going value of the exchange rate is inconsistent with the relationship that the domestic price level has with (comparable) prices prevailing in a country's major trading partners. The Cassel purchasing power parity (PPP) approach for determining a currency's correct exchange rate was, thus, an attempt to devise a way for governments to set equilibrium currency values if they again wanted to peg to gold.

Market forces yielded place to policy-making when PPP was followed by the elasticities approach to balance of payments. That debunked devaluations, saying they would hardly help if the domestic demand for imports remained inelastic in the devaluing economy, while the demand for exports in importing economies was price-inelastic too. The devaluing economy would then be left importing unchanged quantities fetching lesser amounts of foreign exchange! Hence was born the elasticity pessimism doctrine. The policy prescription for avoiding such an impasse was that devaluing governments should also cut money supply to quell internal demand (or, absorption) to enlarge exportable surpluses. That was the absorption approach to exchange rate determination. Policy-makers then had to either adopt the hard way of implementing a contractionary monetary policy by deflating the economy, or do just the opposite and keep supporting demand and continue running up current-account deficits.

Bretton Woods Agreement

The answer to competitive devaluations was the post-War Bretton Woods Agreement (1944), which established the IMF and The International Bank for Reconstruction and Development (IBRD), namely the World Bank. The IMF was made responsible for ensuring a smoothly functioning world payments system, while the World Bank was established to provide the second pillar of the emerging post-war economic order.

All IMF member countries - whether industrial or developing - were expected to tailor their macroeconomic policy to ensuring that the established exchange rate parities would be respected. A truce of sorts, IMF pegged the dollar at US\$35 to 1 oz of gold, and set a rigid regime for remaining currencies. A regime of fixed exchange rates was introduced, with the IMF keeping vigil over these to ensure a smooth functioning of the world payments system. The gold standard was abandoned, but world currencies under the fixed exchange regime were still tied to gold. This effectively meant that countries had to keep their balance of payments current accounts at manageable levels. An exchange rate adjustment was held to be an exceptional, virtually last resort measure to correct a "fundamental disequilibrium" in the balance of payments, and required the Fund's prior approval.

Devaluations, or otherwise, would have to be hard-fought, and after much convincing of the IMF board. But that suited the United States. It allowed them to fuel economic expansion with no fears of any downward pressure on the dollar. Thus, inflation was no problem for them, especially since they did not have to compensate for accelerating prices by interest rate rises. The dollar-gold parity-fix also induced capital account inflows since US dollar-denominated assets provided a safe haven.

Breakdown of the Bretton Woods System: An Era of Free Exchange Rate

1969-1973: Saw the breakdown of the Bretton Woods System, after the US could no longer finance its trade deficits either through hard currency or gold. In 1971, after the breakdown of the Bretton Woods system an era of freely fluctuating exchange rates was ushered in when the dollar glut, resulting from continuing United States balance of payments deficits, caused the United States to abandon the dollar's established parity with gold.

It is only out of self-interest, and a preference for predictability, that treasuries thereafter have tried to keep currencies within a restricted band against others.

This development had profound consequences for the functioning of both industrial and developing economies. The goal of maintaining stable exchange rates had constrained domestic macroeconomic management to keeping the balance of payments viable.

Expansionary policies led sooner or later to unsustainable current account deficits through both price effects (because of the inflationary pressures) and income effects (by creating increased demand for imports). In the absence of exchange rate adjustment, the situation could only be set right by deflation and economic contraction. As economic management lost the tether of fixed exchange rates, the industrial countries found themselves able to pursue macroeconomic policy as though there was no balance of payments constraint. The consequence was a general acceleration of inflation in the 1970s. Flexible exchange rates - which directly or indirectly were related to higher inflation, the higher price of oil following the OPEC action in 1973-1974, increasing international liquidity, and greater independence of countries in the exercise of macroeconomic policy - paved the way for the liberalization of capital markets and the removal of controls over capital movements in the industrial countries.

The flows of capital- debt, portfolio equity, and direct and real estate investment- between one country and others are recorded in the capital account of its balance of payments. Outflows include residents' purchases of foreign assets and repayment of foreign loans; inflows include foreigners' investments in home-country financial markets and property and loans to home-country residents. Freeing transactions like these from restrictions- that is, allowing the free flow of "outflows" advantages foreign investors- and by extension- encourages international trade, whilst the downside could be a hemorrhage to the country's balance of payment.

Classical economic theory argues that international capital mobility allows countries with limited savings to attract financing for productive domestic investment projects, that it enables investors to diversify their portfolios, that it spreads investment risk more broadly, and that it promotes intertemporal trade- the trading of goods today for goods in the future. More specifically:

- Capital mobility means that households, firms, or even countries can smooth consumption by borrowing money from abroad when incomes are low in the home country and repaying when incomes are high. The ability to borrow abroad can thus dampen business cycles by allowing households and firms to continue buying and investing when domestic production and incomes have fallen.
- By lending money abroad, households and firms can reduce their vulnerability to domestic economic disturbances. Companies can protect themselves against sudden cost increases in the home country, for example, by investing in branch plants in several countries. Capital mobility thus enables investors to achieve higher risk-adjusted rates of return. In turn, higher rates of return can encourage saving and investment that deliver faster economic growth.

The "Washington consensus" holds that good economic performance requires the deregulation and liberalization of trade and finance, macroeconomic stability (based on tight monetary and fiscal policy to achieve low inflation), and getting prices right, all of which entail less "government" and greater reliance on the market, and hence

privatization too. Proponents of the Washington consensus policies consider that aligning domestic prices with world prices is the best way for developing countries to achieve an efficient allocation of resources and more rapid, sustained overall economic growth. Hence the emphasis on appropriate exchange rates, the removal of restrictions on exports and imports, and unrestricted capital flows.

As private external financing became more prominent, capital controls were gradually dismantled in the advanced countries such that today there are virtually no controls on capital movements as far as the industrial countries are concerned and exchange rates are generally free to fluctuate. Many developing countries have also liberalized their capital markets, in order to attract foreign direct and portfolio investment. With exchange rates unstable and no effective controls on capital flows, countries have found it difficult to manage their economies and prevent financial crises from occurring.

A slight deviation of the exchange rate or interest rate from market expectations can cause "a run" on the currency and financial instability. Industrial country commercial banks were the direct beneficiaries of the rising fortunes of the oil producing countries, since there was disagreement over alternative schemes to "park" the mounting oil revenues. It was because of the increased liquidity that commercial banks, initially rather tentatively but later aggressively, became increasingly prominent as suppliers of foreign finance to developing countries. The Indonesian Pertamina Crisis of 1974 marked the first casualty of excessive (and irresponsible) commercial bank lending, which in a few years was followed by the trauma of the Latin American debt crisis.

Private Capital Flows and Financial Crises

Over the last 25 years, the countries of the South have witnessed a number of major debt or financial crises, starting with the Pertamina crisis of 1974, which broke when it was discovered that Pertamina, Indonesia's state-run oil company, could not service its accumulated external debt, virtually all owed to foreign commercial banks.

The Latin American debt crisis of the early 1980s, which was set off by Mexico's default on its external debt in August 1982, had its roots also in the oil boom of the 1970s: Mexico's inability to meet its large short-term liabilities

The support of the IMF and the World Bank came with "conditionality". The focus of policy reforms to turn the bankrupt economies of Latin America (and other regions) into commercially viable ones was a universal diminution of the state's role, trade liberalization, deregulation, privatization, and stringent fiscal and monetary policy. However, the policy shifts in favor of the market, whatever its merits- sowed the seeds for the next major financial crisis - that of December 1994 - that again erupted in Mexico when the peso became indefensible.

Once again the IMF came to the rescue by providing large-scale financing (some US\$ 50 billion, or roughly the amount Mexico owed to private foreign bond-holders and other investors) to stop the currency's collapse. The crisis was brought under control relatively quickly and its impact on the other Latin American economies, though considerable, was more or less contained. Capital account convertibility enabled wealthy Mexican citizens to convert their pesos into foreign currency in order to acquire foreign - mainly dollar-based - assets. This capital flight abroad could only be financed to the extent that the Mexican government was able to continue to engage in short-term foreign borrowing

The dramatic rise in private capital flows during the 1990s was a cause for much euphoria among those urging free markets and economic liberalism. It was held to be the evidence of the private sector's ability to promote world trade and economic growth through freely functioning world capital markets. The East Asian miracle economies became a major attraction for foreign investors during the 1990s. These economies were well managed, had been growing rapidly, their exports were internationally competitive, governments were well disposed to foreign investment, and labor was hardworking, well-trained, and motivated. With stock markets expanding, and privatization of several public enterprises underway, these were ideal emerging markets, promising high returns with relatively low perceived risk. The East Asia region as a whole received almost US\$ 500 billion (or a little under 40 per cent of the world total) in net capital inflows during the five-year period 1993-97. About 60 per cent of the inflows consisted of FDI and portfolio investment.

However, the euphoria came to an abrupt halt when Thailand devalued its currency in July 1997 which set off a chain reaction that has engulfed the East Asian economies in what is perhaps the most serious financial and economic crisis since World War II.. A number of observers have explained the East Asian crisis in terms of misguided investments in real estate, "crony capitalism" in which governments and private enterprises engaged in reciprocal favors, lack of prudential regulation of domestic financial institutions, and various other failures. Rightfully or wrongfully, a combination of these factors contributed to the malaise:

A severe financial crisis is bound to inflict pain of adjustment on an economy. But most of times it was felt that adjustment reduces, rather than enhances, the economy's ability to cope with the crisis. More often than not, policy reforms of IMF embedded with policy prescriptions can hardly be regarded as a remedy. The IMF has therefore come under considerable criticism from all quarters including well-known mainstream economists.

The World Bank also has questioned the soundness of the IMF's diagnosis and the standard remedies prescribed for the countries in deep trouble. These comments are a welcome addition to the more longstanding critiques of the "Washington consensus". There are few countries in Latin America or East and Central Europe where conditions for satisfactory economic growth have been restored. In fact, a situation of declining

output and incomes makes the restoration of economic stability much more difficult. That is why a number of countries in Africa and many economies in transition find themselves entrapped in a downward spiral of economic decline and instability. This points to a fundamental problem with the IMF's standard package of reforms: recommending expenditure cuts in a deflationary situation to achieve economic stability is likely to be self-defeating.

The herd –like behavior of private lenders or portfolio investors is one of important reasons for not being able to anticipate the difficulties that their actions create, especially with respect to developing countries. The herd-like behavior on the part of lenders and portfolio investors is particularly common with regard to their investments in developing countries, where higher returns are associated with higher risk.

Investors also converge on a specific area; expectations of a high return can become self-fulfilling. Investing in an asset whose supply is relatively fixed in the short run (land, urban property, stocks, works of art, etc.) merely pushes up its price. This can cause a spiral of rising investment and rising asset prices, with expectations of higher returns being continuously realized. Stock market bubbles are quite common.

Sometimes over-investment can be caused by information failure. Investors know that sooner or later the boom in asset prices will burst, but they cannot know exactly when, as it depends on others' actions. In other words, an investor needs to anticipate competitors' expectations about the market. Given this dual uncertainty, it becomes difficult for an individual investor to be the first one to pull out of a booming market. It is usually an outside event (a political crisis, for example) that pierces the bubble, and causes the withdrawal of investors and fall in asset prices.

It has been observed that almost in all capital flow–related financial crises of the 1990s there was considerable currency mismatch on the balance sheets of both public and private borrowers (Fischer 2001; Goldstein 2002). The currency mismatch resulted because of a fixed peg or crawling band exchange rate regime virtually adopted by these countries. When countries maintain such exchange rate regimes (fixed pegs or crawling bands), investors and borrowers may believe there is less need to hedge currency movements, and the risk of borrowing in foreign currency appears to be reduced, encouraging excessive exposure. (Goldstein 2002)

An important feature distinguishing the Mexican (1994) and East Asian crises (1997) from previous episodes of crisis is the macroeconomic impact of private capital flows. Earlier developing countries resorted to foreign borrowing in order to fill the resource gap created either through inadequate domestic savings or export earnings. The recent capital inflows, on the other hand, were driven largely by the prospect of high returns in markets that were being opened up to foreign investors and they exerted a powerful influence on the macro economy.

A conspicuous feature of all financial crises has been that the borrowers have been made to bear the brunt of financial and economic adjustment. There has not been a single instance of bankruptcy of private lending institutions in industrial countries on account of lending to developing countries. The debt-workouts (such as the so-called Brady plan for the resolution of the Latin American debt problem) have so far focused on *financial* mechanisms that make "orderly" debt repayment possible, rather than on means to return of the indebted countries to creditworthiness through income and export growth. The result is that, after more than a decade, Latin America remains traumatized by the consequences of the debt crisis.

Flexible Exchange Rates and More Open Capital Accounts

The argument for free capital movement rises from the premise that free capital mobility will bring in greater efficiencies in global allocation of capital as also diversification of risk that will lead to greater gains in economic growth and welfare. It has been realized that capital inflows and outflows have a greater effect on domestic inflation, monetary transmission, and financial stability in developing countries than in developed countries. Therefore, policies on exchange rates and capital controls are particularly important for developing countries. Most developing countries are already more open to international trade in goods and services than are developed countries: from 2002 to 2004, developing countries' trade averaged 54.5 per cent of GDP, compared to 39 per cent in developed countries. But developing countries as a group also face a potentially higher degree of volatility in capital flows, and changes in the exchange rate may translate more quickly into domestic inflation than in developed countries. Even with their recent progress (in launching local-currency debt issues on global markets), developing countries still have much larger shares of their external debt denominated in foreign currencies than do industrial countries (Eichengreen and Hausmann 1999; Hawkins and Turner 2000). Such conditions predispose an economy to greater vulnerability to external financial shocks. The concern is that information asymmetry might lead to distortions in capital allocation that might lead to imbalances.

The world has seen greater mobility of capital in the 1990s, and at the same time also witnessed financial distress in several countries. This happened as countries increasingly adopted capital account convertibility (Re Article VIII, IMF)- some on their own as a part of their broad economic agenda- and some as a part of economic restructuring; the pace of this transition varying across countries. Since the early 1990s, nearly 50 developing countries have abandoned fixed or crawling pegs in favor of managed floats or fully flexible exchange rates (Figure 1). Notable examples are Mexico (1994), Indonesia (1997), Colombia (1999), Brazil (1999), Chile (1999), and the Russian Federation (2002). In July 2005, the Bank Negara Malaysia adopted managed float for the ringgit with reference to a currency basket and the People's Bank of China revalued the renminbi and announced that it would be determined with reference to a currency

basket. ((Global Development Finance: The Development Potential of Surging Capital Flows 2006: Review, analysis and outlook)

The trend toward greater exchange rate flexibility is likely to continue as deepening cross-border linkages increase the exposure of countries with pegged regimes to volatile capital flows because flexible regimes offer better protection against external shocks as well as greater monetary policy independence.(David Cheney, based on IMF Working Paper 04/126,“From Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility,” by Rupa Duttagupta, Gilda Fernandez, and Cem Karacadag.)

Currently, it can be observed that countries with capital convertibility on a voluntary basis have achieved better macro economic outcome with free float. Evidence of US economy growing continuously despite huge current account deficit to an extent is attributed to the availability of global capital flows. But such an advantage might not be possible in all countries.

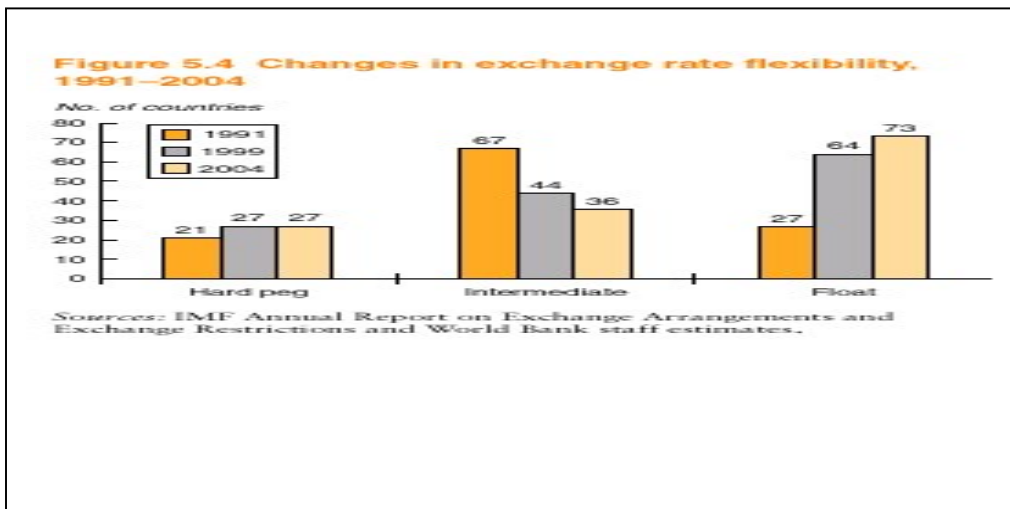
It has been argued that as countries open up their capital accounts, an increase in capital outflows and a change in the composition of flows will result in enhancing economic growth. Their main impetus will shift from stimulating growth through additional investment to enhancing productivity. But impact of capital flows on growth is influenced by successful management and operation of a flexible exchange rate regime, market microstructure, and institutions to ensure smooth functioning of foreign exchange markets.

Developing countries have become more integrated with the global economy. In the past decade, with rising incomes in developing countries and increasingly open policies toward trade and financial markets, developing countries have become a significant source of FDI, bank lending, and even a source of official development assistance (ODA) to other developing countries. Overall, growing FDI between developing countries in recent years has sometimes compensated for reductions in FDI flows from high-income countries. But South–South capital flows, in particular, have also opened opportunities for low-income countries, because developing-country investors are often possibly better able to handle the special risks encountered in poor countries. Banks from developing countries play an increasingly prominent role in cross-border lending to low-income countries; borrowers in low-income countries received 17 per cent of total South-South cross-border syndicated lending flows in 2005, up from 3 per cent in 1985. Moreover, 27 per cent of foreign bank assets in low-income countries are held by developing-country banks, compared to just 3 per cent in middle- income countries. South–South FDI is significant for many low-income countries, particularly those located close to major investors. (Global Development Finance: The Development Potential of Surging Capital Flows 2006: Review, analysis and outlook)

Policy decisions must be made about whether to rely on interest rates and intervention to stabilize exchange rates at times of high volatility or uncertainty. Such decisions

require an assessment of the underlying sources of exchange rate volatility, which in the context of many developing countries often implies gauging the sustainability of capital flows. For example, policy makers might ask whether a surge in capital flows was composed primarily of volatile portfolio capital or speculative debt, on the one hand or more stable and predictable FDI flows, on the other. The appreciation in real exchange rates in the last few years has been much milder. Latin America shows stronger appreciation over 2004–5 than does East Asia. Looking at some individual countries, the real exchange rate appreciated some 60 per cent in developing countries over the period 1993–1996, while only about one-third experienced an appreciation in 2002–2004.

Fig 1: Changes in Exchange Rate Flexibility, 1991-2004



In a highly interdependent and integrated global economy, developments in the United States are very likely to influence the pace and growth of emerging economies. As such, it is pertinent to follow closely the developments in the US.

The low rates of interest have encouraged US consumers to borrow and invest, especially in real-estate. The cost of production however remains high in the US because the low interest rates only partly compensates for the high cost of labor. The competitive advantage remains against the US. The Internet economy moreover has led to loss of jobs at call-centers, research, design and clinical trials. As a result, the US consumers have not been able to make their mortgage payments. The problem is compounded by the growing US trade deficit.

Presently, US exports are less than imports by about \$600 billion. The US needs to import this amount of world capital to pay for its imports. While the low interest rates

have created the demand for goods, it has also discouraged investment in US Treasury Bills by foreign investors with the result that the deficit has further widened.

The Fed has had to step in and raise the interest rates to encourage foreign investors to continue buying US T-Bills. This undid the efforts to raise consumption through low interest rates. Now, the US consumer is faced with two problems. On the one hand, he is losing his job and income. On the other, he faces higher interest payments on mortgages. The number of defaults is increasing. Until recently, these banks were borrowing in Japan at low rates of interest and lending to US consumers at a hefty margin. That was all right as long as the rate of exchange remained stable. But the loss of competitive edge and high interest rates in the US economy are ominous signs of an impending devaluation of the dollar. Banks are, therefore, rushing to repay the Japanese loans before the dollar crashes. They face a liquidity crunch here. It takes time to sell non-performing mortgages while the Japanese loans are to be paid promptly. This situation is likely to continue until the US banks are to set their house in order.

It is likely that the US economy will go into a recession because the fundamentals are not exactly robust. But that will still not impact emerging economies adversely. The decline in the US economy has two opposite impacts on emerging economies.

On the one hand, its exports will be adversely affected. On the other, a decline in the US economy and the fortunes of American companies are likely to lead to more foreign investment inflows into emerging economies. Investors are likely to dump US securities and invest in newly emerging economies.

Petro-Dollar and Capital flows

Higher oil prices have had a major influence on the external and fiscal positions of most developing countries. For net oil *exporters*, higher oil prices have meant significant increases in external and fiscal surpluses, and higher foreign exchange reserves. For net oil *importers*, healthy current-account surpluses and ample foreign ex-change reserves made it possible to cover the sizable increase in oil-import bills.

But currently the surplus hoarded by the OPEC countries and other oil exporters is such as to dwarf the volume of currency hoard in the hands of China and other Asian nations. To cite an example, Saudi Arabia's current account surplus alone is quite large. The surplus of Saudi Arabia, the UAE and Kuwait has risen to 30 per cent of their GDP, compared to China's 8 per cent.

The surge in oil prices over the last decade, barring a slight fall in 2006, has led to these countries accumulating huge surpluses, which they have invested in dollar-denominated assets. The cumulative surpluses of all oil-exporting countries in the five years to end-

2007 amounted to US\$1.7 trillion. This is larger than China's accumulated surplus in the same period.

Oil exporters are afloat in a flood of cash. This is being invested through government investment funds which, in turn, use intermediaries in London to deploy the same in Treasury securities, bonds, real estate and equity. Unlike in the 1970s and 1980s when petro-dollars fed directly into US bank deposits and into investment banks, leading to an explosive increase in lending to Latin America and its subsequent collapse due to the US interest rate hike, this time the flood is more diversified. Even so, it is a partial cause of the current flood of liquidity, leading to asset price bubbles.

More importantly, it is buoying parts of the American economy, inevitably maintaining its budgetary excesses, including its defense spending and housing boom. It is also helping to sustain over a long period the low interest rate regime in the US in spite of rising deficits.

While the US and its policy-makers are prevailing on China to keep its exchange rate policy flexible, meaning that it should revalue the Yuan and stop intervening in markets to buy up dollars, it does not extend the same advice to the petroleum exporters. The important difference is that oil exporters, by and large, have been linking their currencies to the dollar. Thus, when the dollar falls, as has been the recent trend, their currencies also fall. This dollar peg keeps their currencies at a lower value than warranted by their robust terms of trade. This leads to their imports becoming costlier. Besides, oil exporters suffer the penalty of being paid in a continually eroding currency - the dollar.

The oil-exporters' economies are also being persuaded to buy more US goods, especially defense equipment. The attempt by the US is to restore balance by exporting more to these countries. The obvious remedy is, however, to reduce the US dependence on imported oil. In this context, it is interesting to note that the US is showing increasing awareness of the resource drain that the US' thirst for oil is posing.

The flood of petro-dollars and its disposition has an impact not only on the US but also on emerging markets. The flood will inevitably find its way into emerging markets through intermediaries, including hedge funds.

This can be a potential source for booms and busts in the stock market. Regulators in emerging markets have to beware. The sources of recent volatility can be traced not only to the fluctuations in Japan's yen carry trade, but also in the ways petro-dollars behave.

This can be a potential source of trouble as well as a blessing for emerging economies. If petro-dollars can be canvassed for essential investment in infrastructure in emerging markets, it can prove a beneficial source.

There is need to focus policy-makers' attention on attracting petro-dollars into emerging markets. This is, of course, without prejudice to the general problem of abundance of forex reserves that emerging markets are privileged to endure at present. One has obviously to concentrate on the quality of petro-dollar inflows; the more as FDI, the better.

It is, indeed, a paradox of global economics that the superpower of today is being funded to buy its life-blood - oil - by the very owners of oil resources. They are also incidentally funding the budget excesses of the superpower. The process is helping to keep US interest rates low and housing boom alive. The oil exporters are also perhaps well advised to diversify away from over dependence on oil. Broadening their productive base would be the prescription.

Foreign Exchange Reserves Paradox

Foreign exchange reserves in some emerging economies are built up more out of volatile capital flows and equally volatile foreign residents deposits, which can erode over time, than out of current account surpluses. This enforces the need for segregating a part of the reserves that can be traced to more sustained flows. These countries do not have access to current account surpluses that are the main strength of countries such as China.

This means, it is important that even as these countries embark on an aggressive policy of market-related investment of part of foreign exchange reserves, these should concentrate on undertaking an export enhancing policy that would reverse the current account deficit.

It is interesting to note from Table-2 that China alone has over US\$1 trillion in foreign exchange reserves. China's neighbors, such as Taiwan, Hong Kong and Singapore, have between themselves another US\$300 billion.

The ascent of the Euro and its increasing use in debt issuance can be attributed to the fact that it is the home currency of a large set of investors. However, it is less popular as a currency of denomination for reserves, owing to the dominance of the dollar as a vehicle for foreign exchange transactions and currency interventions- as well as the greater liquidity of the market for U.S. Treasury securities. Nevertheless, if the deteriorating U.S. current-account deficit sufficiently undermines confidence in the dollar, more official reserve holdings could shift into euro-denominated assets, with the potential for a period of financial in-stability if the shift is abrupt.

Table 2; Foreign exchange reserves (forex) of selected countries

Forex reserves of various countries	
	(in \$ bn)
Forex reserves	
China	1066
Japan	905
Russia	311
Taiwan	268
South Korea	242
India	193
Singapore	136
Hong Kong	136
Germany	113
Brazil	101

Financial innovations

Currently, innovated financial products in developing countries include a range of instruments in both local and foreign currency that offer the capacity to tap dollar and euro investors alike and cater to the funding needs of both sovereign and corporate borrowers on both the cash and derivatives sides of the market. Temasek, the company that manages Singapore's US\$100-billion-plus dollar reserves safely and profitably, has proved it is a model worth replicating.

Credit default swaps- derivatives have potentially important implications for the pricing and supply of debt capital to developing countries. These in developing countries are offering investors a new way to take on exposure and enhancing the markets' ability to gauge credit risk. While the emergence of this market could improve the ability of financial systems to diversify risk across a greater number of market participants, it remains a relatively immature and potentially vulnerable market because of infrastructural shortcomings, a lack of regulatory frameworks robust enough to cope with the market's dynamic nature, and the concentrated participation of a small number of dealers in emerging markets, which carries the risk that failure of a single player could have a destabilizing impact on the market.

Domestic Debt Markets

Local-currency bond markets in developing countries have recently emerged as a major source of long-term development finance. This market is driven largely by domestic institutional and individual investors. Debt markets in these economies grew from US\$1.3 trillion at the end of 1997 to US\$3.5 trillion in September 2005. This has facilitated in reducing currency and maturity mismatches. Robust domestic bond markets have also improved financial intermediation and contributed to domestic growth, as both the government and corporate sectors have readier access to long-term

capital. However, bringing the local-currency bond markets in emerging economies up to the standards of mature markets will require concerted efforts akin to those of the East Asian countries, which have yielded early successes.

But local-currency debt markets also present new challenges for policy makers. The development of domestic debt markets requires modern and professional debt management procedures- to manage debt on an integrated basis (that is, both local and international debt)- especially in countries with few capital controls.(Global Development Finance: The Development Potential of Surging Capital Flows 2006 : Review, analysis and outlook)

The Global Role of the Euro

The Euro has emerged as a principal issuing currency in the global debt market; Euro facilitates foreign exchange transactions, and also act as an important reserve currency for official holdings of foreign-exchange reserves. The elimination of exchange risk within the Euro Area has created a pan-European market for Euro-denominated securities, attracting both sovereign and private borrowers, not only from Euro Area countries, but also from other countries- among them emerging market economies such as Brazil, Colombia, China, Mexico, and Turkey. Today's Euro denominated bond market rivals the dollar-based fixed-income markets in important respects, including size, depth, and product range.

Managing Free-Capital flows

Free capital inflows can inflict destabilizing side effects, including a tendency for the local currency to gain in value, undermining the competitiveness of export industries, and potentially giving rise to inflation. This erodes the profitability of the tradable sectors (mostly, agriculture and manufacturing), by making exports more expensive and thus causing the trade balances to worsen, which in turn increases the dependency on foreign inflows. The outflows, on the other hand, necessitate domestic demand cuts, which result in a fall of domestic output. In a highly open economy, the situation can quickly turn into a financial crisis brought on by the flight of capital, currency depreciations, and interest rate increases.

To ease the threat of currency appreciation or inflation, central banks often attempt "sterilization" of capital flows. . Sterilization can happen directly through the appreciation of the exchange rate in the currency market, because of the excess supply of the foreign currency, or through the build up of foreign exchange reserves that leads to an increase in the money supply and domestic demand and, ultimately, to accelerated inflation. In the latter case, because domestic prices rise faster than foreign

prices, there occurs a real appreciation of the exchange rate even if the nominal rate is not allowed to appreciate. Once the economy gets used to the higher trade deficit, which essentially implies a higher level of expenditure, it becomes difficult to adjust to lower levels when the supply of foreign finance declines or reverses its direction.

Through sterilization, the domestic component of the bank reserves plus currency is reduced to offset the reserve inflow for a short period. This can be done by encouraging private outbound investment, or allowing foreigners to borrow from the local market. Sterilization, however, has been through the use of open market operations, that is, selling Treasury bills and other instruments to reduce the domestic component of the money supply. But sometimes, a rise in domestic interest rates can defeat the sterilization measures and stimulate even greater capital inflows.

Issuing a large stock of securities in an attempt to mop up the inflowing liquidity often places a heavy debt-service burden on the central bank. In some cases, such as in Chile and Colombia, it has led to the deterioration in the fiscal or quasi-fiscal balance (which includes the accounts of parastatal enterprises). For a central bank, operating losses can occur when the funds it raises are invested in foreign assets, which earn prevailing interest rates in the major world currencies--often lower than rates the central bank must pay on the bills it has sold. Large-scale losses can even lead to the need for a recapitalization of the central bank. In a worst-case scenario, the building up of a central bank or Treasury balance sheet may also expose it to greater credit risks, making the whole system more vulnerable to a sudden reversal in capital flows. This is more likely where much of the capital inflow is in the form of short-term portfolio investment, which can be reversed much more quickly and easily than foreign direct investment.

Some developing countries, along with sterilization measures, have also adopted some supplementary measures. These are wider-band exchange rate policies and forward exchange market intervention to capital controls, such as variable deposit requirements and interest equalization taxes on foreign borrowings. Some examples of these instruments:

Discount Policy and Directed Lending

This entails contracting money supply through increasing the cost or restricting access to central bank credit. However, discount policy cannot be expected to play a prominent role as a flexible policy instrument. In many developing economies, rediscounts and loans granted by the central bank are often an automatic tool for priority lending extended via commercial or specialized banks to specified sectors of the economy.

Reserve Requirements

Increasing statutory reserve requirements--the proportion of assets that commercial banks must hold on deposit with the central bank- is another method of limiting the expansion of credit. In some countries, such as Colombia (1991), reserve requirements have been raised sharply to try and sterilize capital inflows.

Government Deposits

Another way to absorb reserves is to shift public sector deposits from commercial banks to the central bank. Where public sector deposits account for a large slice of the banking system's deposit base, as in Malaysia and Thailand, the use of this method has been highly effective in sterilizing capital inflows.

Foreign Exchange Swaps

This is when the Central bank agrees to sell foreign exchange against the domestic currency and simultaneously agrees to buy it back at a specified date in the future, using the forward exchange rate.

Wider Exchange Rate Bands

In response to large and persistent capital inflows, Chile (1992) and Colombia (1993) have widened the exchange rate band for their currencies. The most obvious benefit of doing this is that, by allowing some exchange rate appreciation, import prices tend to fall. With import prices dropping, there is downward pressure on inflation, so reducing the need to sterilize all capital inflows. A wider band may also reduce inflows that are stimulated by perceptions that the currency is undervalued- and expose such speculators to greater risk of short-term fluctuations. If the appreciation is rapid, this should also reduce the incentives for domestic speculators. Above all, a wider band allows the central bank more flexibility for intervention in the foreign exchange market, which can be important if there is a sudden reversal of sentiment.

Easing Restrictions on Capital Outflows

A number of developing countries have tried various ways to offset capital inflows by relaxing controls on capital outflows. Relaxing restrictions on outflows may include such measures as easing surrender requirements on foreign exchange earnings, permitting local institutions to make investments abroad, or allowing non-domestic entities to issue

local-currency bonds in the domestic market. Such measures will only work, of course, if the restrictions were effective in the first place.

Variable Deposit Requirements

To discourage capital inflows, recourse has been made by a number of countries to the introduction of a deposit requirement, whereby a certain percentage of foreign currency borrowed by domestic residents must be placed with the central bank in interest-free, non-assignable deposits for a fixed period. This effectively serves as a tax on foreign borrowing. The percentage and the deposit holding period can be varied, and may be adjusted frequently in response to changing conditions.

Empirical tests in industrial countries have often found that using capital controls for sterilization purposes has been largely ineffective. In developing countries, however, the statistical evidence so far (at least from this admittedly small sample) is somewhat more positive. Indirect controls are less distortionary and more transparent than direct restrictions, although they do have disadvantages, including the potential to distort resource allocation, as well as administration costs. Nevertheless, the evidence shows that the use of variable deposit requirements, such as in Spain (1987 and 1989), and interest equalization taxes (although the only recent example is Brazil) can have at least some temporary effect in reducing capital inflows.

Chapter 3: Foreign Direct Investment: Trade and Development Implications

Overview

An examination of the relationship between capital flows and foreign direct investment and its implications on trade and development would require a rigorous analysis. In principle, both capital flows and foreign direct investment are variables affected by third factors such as the investment climate, productivity, international interest rates, and economic growth. Factors that stimulate foreign investment also tend to attract capital flows (and vice versa), there being a high correlation of capital flows with investment is not surprising. The influence of third variables also suggests that the relationship between capital inflows and foreign investment is nonlinear, in that capital inflows have a positive and significant effect on investment only once a threshold level of financial and economic development has occurred.

Inflows of foreign direct investment are determined by a complex set of economic, political and social factors and investors look beyond the array of investment incentives (in particular fiscal incentives) offered. Performance requirements and various

restrictions and regulations act as disincentives to foreign direct investment and often serve to offset the positive effects of investment incentives. What matters most for the foreign investors is their ability to reduce business risk, increase profitability to repatriate capital and investment income.

Supporters of FDI contend that foreign investors introduce a package of highly productive resources into the host economy, including production and process technology, managerial expertise, accounting and auditing standards, and knowledge of international markets. The challenge for the host economy is to benefit from the presence of MNEs, and to appropriate some of the increased income accruing from the resultant productivity growth. The large literature on FDI impacts concludes that the host economy benefits are quite uneven, both across and within countries. This suggests that host country policies are an important factor in the distribution of these benefits. Of particular relevance are the commercial environment, institutional quality, and supply-side capacities.

Foreign investors are also attracted by market opportunities (domestic and exports), a clear legal and institutional set up, administrative speed and efficiency, efficient infrastructure services and above all by liberal economic policies and stable macro economic environment.

Although some transnational firms desire to have wholly or majority owned branches or subsidiaries, it is widely held that some form of joint venture with a host country partner is preferable because of the experience and insights local partners bring. Local partners are particularly effective in managing labor and dealing with regulatory issues. FDI flows are facilitated by full currency convertibility, free repatriation, less performance criteria, tax holidays and other incentives, abolition of screening requirements, relaxation of sectoral limits on foreign equity. The macro-economic policy framework and reforms constitute only some of the factors, albeit vital ones, for encouraging foreign investment. The country's economic potential, human and natural resources, political stability, and other factors that affect the risk and profitability of investment are equally important. Membership in bilateral tax treaties, and multilateral and regional investment guarantee arrangements are seen as an important element in providing a stable and attractive framework as it could reduce perceived risks.

Other factors influencing FDI include

- Domestic market potentials
- Skilled labor force at reasonable wage rates
- Low transactions costs
- High rates of return
- Labor mobility
- Efficient infrastructure
- Established legal and institutional set-up

- Transparent rules and regulations
- Administrative speed and efficiency

The availability of Special Economic Zones and Economic Processing Zones to foreign investors, as well as the extension of the GATT and WTO fundamental principles of national treatment³ and most favored nation treatment (MFN) to them, the adherence to international standards for investment laws and international arbitration in the case of disputes, the implementation and enforcement of laws relating to intellectual property rights (IPR), and the right to employ management of its choice also attract foreign investment.

The formation of regional trading blocs such as NAFTA, ASEAN, and SAARC also has an important impact on the flow of FDI.

Foreign investors disdain any screening of investment except for national security, public health, individual safety, and environmental protection, and performance requirements such as export orientation, local content, value addition, foreign exchange, as these distort international trade and investment flows, and result in diminished returns to both home and host countries.

In the 1960s, the International Chambers of Commerce argued strongly that developing countries should attract foreign investment with tax 'holidays' and other incentives such as subsidized credit and privileged access to protect domestic markets. The IMF favored the suggestions, but advised that incentives should be extended to all investors.

Since 1980, countries that guaranteed full repatriation of profits attracted 95 per cent of foreign investment; countries adhering to Convention of Settlement of Investment Disputes attracted 90 percent of foreign investment from USA.

The strengthening of local capital and stock markets is essential for the development and broadening of the domestic investor base and the establishment of a healthy private sector. In this respect, privatization has a role to play in broadening the investment base. A prudent regulatory framework along with transparency and efficiency of price dissemination are also necessary to ensure investors' confidence in the stock market. Few developing countries and economies in transition have paid due attention to outward FDI policies; typically these are subsumed under general capital-control policies which, in turn, are quite restrictive. There is a need to liberalize further capital markets and foreign exchange rules and regulations to move towards full convertibility on capital account.

As regards portfolio investment, the enormous potential represented by the pool of savings held by institutional investors in the OECD countries may increasingly seek investment outlets other than those offered by the mature markets. However, home

³ National treatment (Article 3, GATT) requires the importing nation to ensure that the treatment of an imported good is not less favorable than that accorded to a domestically produced product/good.

country regulations concerning outward portfolio investments can be a major constraint on outward portfolio investment. In most developed countries, savings institutions such as insurance companies and pension funds face ceilings on the share of foreign assets in their portfolio and are usually subject to prudent investment and diversification norms. As investment managers become more familiar with emerging markets, a relaxation of home country policies concerning portfolios of institutional investors could lead to a multiple increase of portfolio investment to developing countries.

It is now generally accepted that the distinguishing characteristics of FDI are its stability and ease of service relative to commercial debt or portfolio investment, as well as its inclusion of no financial assets in production and sales processes. Aside from increasing output and income, potential benefits to host countries from FDI inflows include the following:

- (i) **Foreign firms bring superior technology.** The extent of benefits to host countries depends on whether the technology spills over to domestic and other foreign-invested firms.
- (ii) **Foreign investment increases competition in the host economy.** The entry of a new firm in a nontradable sector increases industry output and may thereby reduce the domestic price, leading to a net improvement in welfare.
- (iii) **Foreign investment typically results in increased domestic investment.** In an analysis of panel data for 58 developing countries, Bosworth and Collins (1999) found that about half of each dollar of capital inflow translates into an increase in domestic investment. Their findings suggest a foreign resource transfer equal to 53-69 per cent of the inflow of financial capital. However, when the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and domestic investment.
- (iv) **Foreign investment gives advantages in terms of export market access arising either from foreign firms' economies of scale in marketing or from their ability to gain market access abroad.** Besides their contributions through joint ventures, foreign firms can serve as catalysts for other domestic exporters. In an empirical analysis, the probability that a domestic plant will export was found to be positively correlated with proximity to multinational firms (Aitken et al. 1997). One implication is that governments may encourage potential exporters to locate near each other by (a) creating special economic zones or export processing zones, or promoting clusters, or by (b) conferring special benefits, such as duty-free imports of inputs, subsidized infrastructure, or tax holidays, to help reduce costs for domestic firms in breaking into foreign markets.
- (v) **Foreign investment can aid in bridging a host country's foreign exchange gap.** Two gaps may exist in the economy: insufficient savings to support capital accumulation to achieve a given growth target, and insufficient foreign exchange to purchase imports. Often investment requires imported inputs. If domestic savings are insufficient, or face barriers in being converted to foreign exchange to acquire imports, they may be insufficient to guarantee growth. Capital inflows

help ensure that foreign exchange will be available to purchase imports for investment.

Ways and Motives for FDI

FDI can be made in several ways. First, and most likely, it may involve parent enterprises injecting equity capital by purchasing shares in foreign affiliates. Second, it may take the form of reinvesting the affiliate's earnings. Third, it may entail short- or long-term lending between parents and affiliates. To be categorized as a multinational enterprise for inclusion in FDI data, the parent must hold a minimum equity stake of 10 per cent in the affiliate.

Establishing foreign affiliates usually entails starting new production facilities- so-called green-field investments-or acquiring control of existing entities through cross-border mergers and acquisitions. Recent years have seen a marked shift toward international mergers and acquisitions.

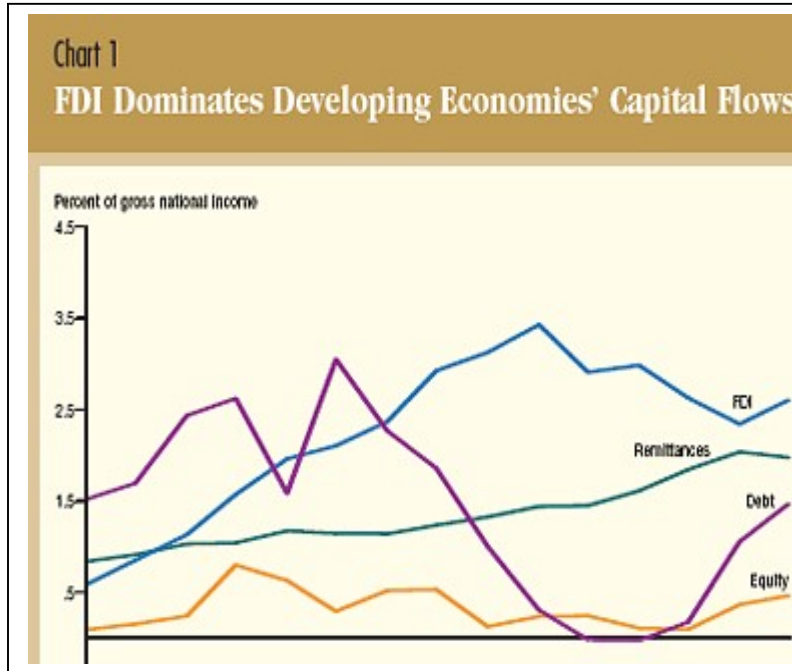
Surveys undertaken by UNCTAD and partner organizations on outward investing firms from developing countries confirm four main motives influence investment decisions by MNCs: *market-seeking*, *efficiency-seeking*, *resource seeking* (all of which are asset-exploiting strategies) and *created-asset-seeking* (an asset-augmenting strategy).

Market-seeking FDI affects in intraregional and intra-developing-country FDI. However, within market-seeking FDI also some differences in patterns of FDI have been noticed.. These are depending on the activity of the MNCs: for example, FDI in consumer goods and services tends to be regional and South-South orientated; that in electronic components is usually regionally focused (because of the location of companies to which they supply their output); in IT services it is often regional and orientated towards developed countries (where key customers are located); and FDI by oil and gas TNCs targets regional markets as well as some developed countries (which remain the largest markets for energy).(World Investment Report 2006)

Efficiency-seeking FDI is from advanced developing countries- those with higher labour costs. Motive is to seek efficiency in operations therefore it tends to be concentrated in a few industries such as electrical and electronics and garments and textiles. Most FDI based on this motive targets developing countries; that in the electrical/ electronics industry is strongly regionally focused, while FDI in the garments industry is geographically more widely dispersed.

Current FDI Scenario

In developing nations, FDI as a share of GDP has grown rapidly, becoming the largest source of capital moving from developed nations to developing ones (**Chart 1**).



Nevertheless, world inflows remained far below the 2000 peak of US\$1.4 trillion. Similar to trends in the late 1990s, the recent upsurge in FDI reflects a greater level of cross-border mergers and acquisitions (M&A), especially among developed countries. It also reflects higher growth rates in some developed countries as well as strong economic performance in many developing and transition economies.

From 1990 to 2005, developing economies' share of total FDI inflows rose from 18 percent to 36 per cent. In addition, the geographical composition of FDI flows has changed dramatically over the past four decades

Within developing economies, Latin America's share of FDI has fallen from 52 per cent in the 1970s to 33 per cent since the 1990s. Asia's share of inflows has risen from 25 per cent to 60 per cent during the same period.

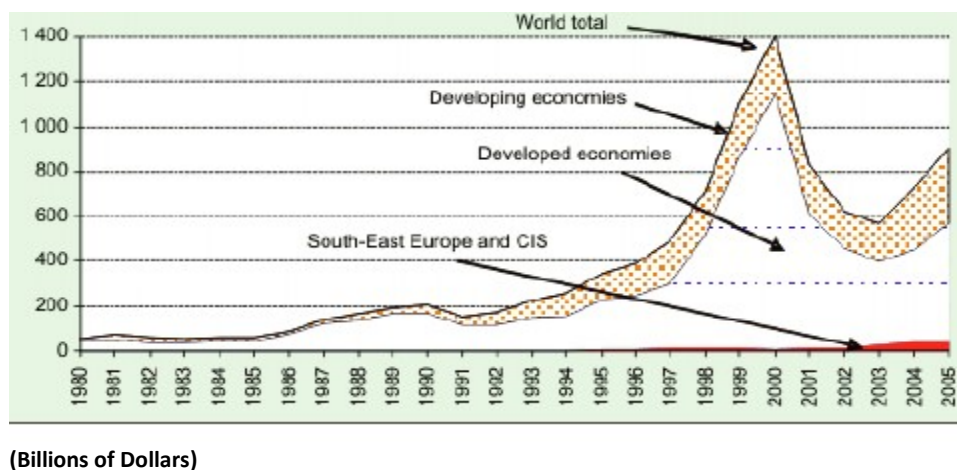
The share of developing countries was 36 per cent and that of South-East Europe and the Commonwealth of Independent States (CIS) was about 4 per cent. Global FDI outflows amounted to US\$779 billion (a different amount from that estimated for FDI inflows due to differences in data reporting and collecting methods of countries). Developed countries remain the leading sources of such outflows. In 2005, the Netherlands reported outflows of US\$119 billion, followed by France and the United Kingdom. However, there were significant increases in outward investment by

developing economies, led by Hong Kong (China) with US\$33 billion. Indeed, the role of developing and transition economies as sources of FDI is increasing. Negligible or small until the mid-1980s, outflows from these economies totaled US\$133 billion in 2005, corresponding to some 17 per cent of the world total.

Within Asia, China and India have gained FDI share relative to Southeast Asia. Today, these two emerging economic giants are the most attractive markets for FDI. China's FDI rose from US\$3.5 billion in 1990 to \$60 billion in 2004, while India's rose from a paltry US\$236 million to US\$5.3 billion. The shift reflects the two nations' more open economic policies, as well as their sheer size and dynamic growth.

A recent IMF report also stated that outward FDI from Asian emerging market countries is expanding rapidly. FDI flows from India, China, Korea, Malaysia, Singapore and Thailand are expanding rapidly and go beyond the well-publicized large investments by Korea's POSCO in other countries. The nature of such "emerging multinationals" also changed over the years. In the past, FDI flows from developing countries resulted from political commitments rather than as an exploration of business opportunities, and involved green field investments in other developing countries. However, in recent years, there had been emergence of global players from the developing countries facilitated by their production, marketing, financial and networking skills supplemented by a specialized knowledge of doing business in non-OECD countries. There had been growing trends of mergers and acquisitions (M&As) by the developing countries as evidenced by the merger between South African Breweries and Miller, that between Tata Steel and Corus Steel, the takeover of International Steel Group by Mittal of India, or the acquisition of the IBM PC business by Lenovo of China, and the attempts to take over US multinationals in the oil and domestic appliances sectors.

Figure 2: FDI inflows, global and by group of economies, 1980–2005



Source: UNCTAD, based on its FDI/TNC database (www.unctad.org/fdi/statistics).

FDI and Its Implications

The most important potential gain for home countries from outward FDI is the improved competitiveness and performance of the firms and industries involved. Such gains may translate into broader benefits and enhanced competitiveness for the home country at large, contributing to industrial transformation and upgrading of value-added activities, improved export performance, higher national income and better employment opportunities. Evidence suggests that under appropriate home-country conditions, improved competitiveness of outward investing firms can indeed contribute towards enhancing industrial competitiveness and restructuring in the home economy as a whole. For instance, broader upgrading has occurred in whole industries in which firms have engaged in outward FDI. Examples are the IT industry in India, the consumer electronics industry in the Republic of Korea and China, and the computer and semiconductor industries in Taiwan Province of China.

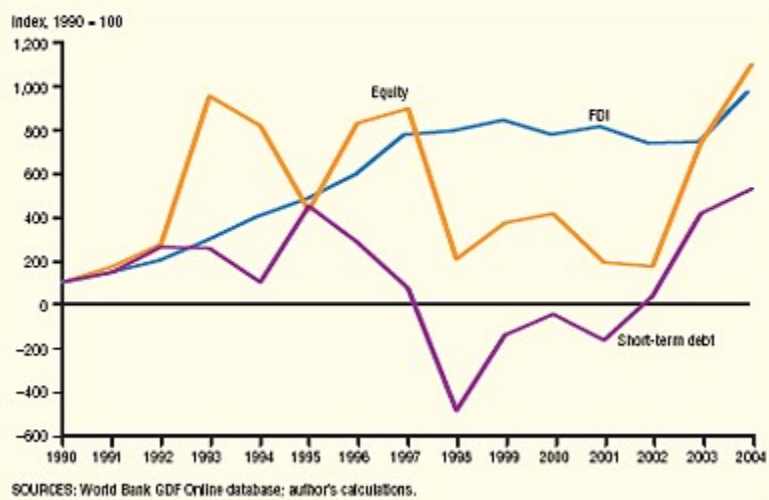
Improved competitiveness of outward investing MNCs can be transmitted to other firms and economic agents in home countries through various channels, including via linkages with, and spillovers to, local firms, competitive effects on local business, and linkages and interactions with institutions such as universities and research centers. In sum, the more embedded the outward investing MNCs are, the greater will be the expected benefits for the home economy.

The rush to invest in places like China and India suggests that FDI will continue to be an increasingly important source of development finance. To better understand these capital inflows and their ripples, we need to examine their effect on key aspects of the receiving countries' economic performance- stability, trade, and development which includes enterprise development, technology, and growth.

FDI's Stability

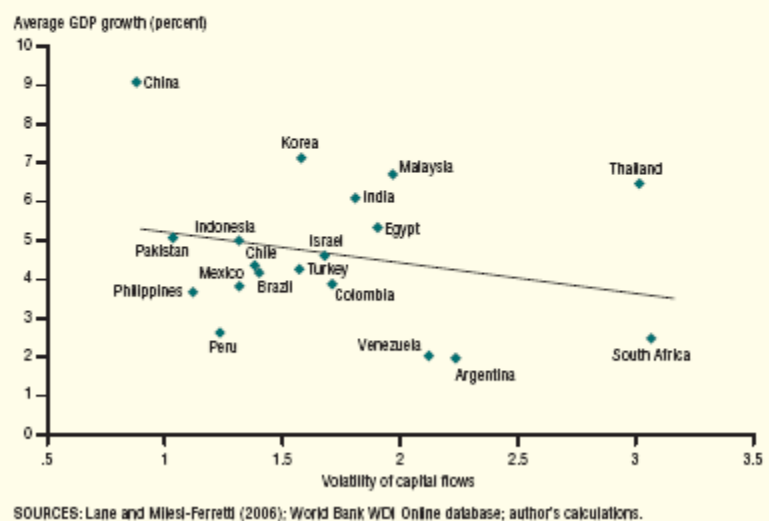
It has been observed that from a development perspective FDI is more stable than debt capital flows. TNCs participation encourages the transfer of advanced technologies in domestic business to the host country, and fosters human capital development by providing employee training. Major financial crisis in the 1990s have occurred because of volatility in short-run equity and debt. As has been depicted in (**Chart 2**) FDI is relatively stable and its long-term character make it the preferred source of foreign capital for many emerging economies.

Chart 2
FDI More Stable than Equity and Short-Term Debt



Various studies of IMF and UNCTAD have established the positive relationship between economic growth and declining volatility of foreign capital flows. Put in another way, higher volatility of foreign capital flow is inversely related to economic growth. **Chart 3** depicts when higher volatility coincided with lower economic performance from 1970 to 2004

Chart 3
Higher Capital Flow Volatility Means
Slower GDP Growth



Foreign Direct Investment and Trade

Many developing countries pursue FDI as a tool for export promotion, rather than production for the domestic economy. Typically, foreign investors build plants in nations where they can produce goods for export at lower costs. Another way FDI helps boost exports is through preferential access to markets in the parent enterprise's home country.

The trade impacts of outward FDI on the home economy depend significantly - as in the case of developed-country FDI - on the motivations and types of investment undertaken. Market-seeking FDI can be expected to boost exports of intermediate products and capital goods from the home economy to the host country. If the motivation is efficiency or cost-reduction, outward FDI could enhance exports as well as imports, especially intra-firm trade, and their extent and pattern, depending on the geographic spread of the MNCs' integrated international production activities. Results of some studies on Asian developing home economies and data on trade by affiliates of developing country MNCs in the United States and Japan suggest a positive relationship between home-country exports and outward FDI from developing countries. (World Investment Report: 2006)

The trade impacts of FDI from developing countries also vary according to motives. Efficiency-seeking FDI is most likely to boost exports, which may include local value addition of various kinds. One recent prominent kind of efficiency-seeking FDI has been in the garments industry, which has had substantial export-boosting effects in LDCs in particular. However, local sourcing and backward linkages in this industry have been limited, with the result that the ending of the Multifibre Arrangement (MFA) quotas has led to a reduction in such FDI, for instance in Lesotho. In market-seeking FDI, especially in manufacturing, the effect is mainly one of import substitution. Resource-seeking FDI, of course, is export-oriented almost by definition, and may allow the host country to diversify its markets.

FDI can also provide a path for emerging economies to export the products developed economies usually sell- in effect, increasing their export sophistication. A new study by Dani Rodrik puts the export sophistication of China, a leading FDI recipient, at least three times higher than that of countries with similar per capita GDP. India, another FDI hot spot, also did well on this score. Some emerging economies are fast becoming attractive destinations for multinationals' research and development centers, suggesting further gains for developing nations.

FDI is an important channel for delivery of services across borders- for emerging economies as well as developed ones. Services are not as widely traded as goods, making up only a fifth of world exports. That figure is expected to rise rapidly, however, as the Internet and other communications make more services tradable and facilitate

the spread of outsourcing. In fact, FDI has grown faster in services than in goods in recent years.

In most developing nations, service industries have been closed to foreign investment. As countries further open their economies, services can be expected to continue outpacing goods. The pattern of services FDI has also been changing. In 1990, finance garnered 57 per cent of services FDI in developing economies. By 2002, its share had fallen to 22 per cent as business services' share rose from 5 per cent to 40 per cent.

As services become increasingly tradable, FDI in these industries can forge a strong link with exports of emerging economies. Multinationals operating in such services as banking, telecommunications and trade enhance the efficiency of homegrown providers in myriad ways, contributing to the export competitiveness of these economies' service sectors. With both FDI and trade rising rapidly in services, FDI has an important role in promoting the sector's globalization in other emerging economies.

Multinational enterprises, the creatures of FDI, play a dominant role in world trade, accounting for two-thirds of all cross-border sales. Foreign affiliates were responsible for more than half China's exports in 2001 and 21 per cent of Brazil's. They accounted for just 3 per cent of India's. At the country's current rate of economic liberalization, however, foreign companies are likely to increase their share of India's exports.

Nevertheless, MNEs are playing an ever more prominent role in the global economy, with crucial implications for countries pursuing an export-oriented development strategy. Compared with a decade or more ago, FDI will now typically (i) be more export oriented, (ii) be less likely to be attracted by the old tariff factory model of production for a protected domestic market, and (iii) account for an increasing share of host economy exports.

Two factors have been driving these trends. The first has been the simultaneous liberalization of both trade and FDI regimes. The second has been technological advances in transport costs and production technologies. The rise of the "global factory" has been made possible by much reduced international transport costs and by disaggregated, transborder production processes, particularly in MNE-intensive industries such as electronics and automobiles. In the most successful cases of these industrial clusters, notably southern coastal China and to a lesser extent the Singapore-centered SIJORI-Singapore-Johore (Malaysia)-Riau (Indonesia)-triangle, production operations constitute a seamless web in which national boundaries virtually disappear.

It is now much more difficult for late-comer industrializers to achieve high rates of export growth without MNE participation (Urata 2001), the more so for transitional economies with a history of international commercial isolation.

There is clear evidence that the strong export performance of developing countries since the 1970s has been closely associated with MNE involvement. MNEs accounted for 24 per cent of total manufactured exports from developing countries around 1980. This figure had increased to 40 per cent around 1990. When given the huge increase in manufactured exports from China, and the increased share of MNEs in this export expansion (from 17 per cent to 48 per cent over this decade), this figure has surpassed 50 per cent by 2000 (Chandra Athukorala).

There are concerns expressed in some quarters that MNCs generate trade deficits rather than trade surpluses. Example, in China. However, it is also relevant to point out that the trade of MNCs in China is shifting from deficits to surpluses as reform progresses and the “dual regime” becomes less important. The initial concentration of MNCs in joint ventures with uneconomic state-owned enterprises (SOEs) can be explained as a major cause for the observed deficits. The trade orientation of MNCs in China has changed rapidly as export-oriented firms have begun to dominate.

Technology and Productivity Spillovers

Technology and productivity spillovers are central to the study of FDI impacts. They constitute the core of MNE competitive advantages, and they feature prominently in host government expectations of FDI. The major general conclusion from Asian country studies is that these spillovers are positive, both economy-wide and for specific industries. However, there are questions about the (i) magnitude of these impacts, (ii) speed of technology transfer

Magnitude of Impact

In the case of Thailand, Archanun (2003) found that spillovers from foreign- to domestically owned firms in manufacturing industries were significant. They were more likely to occur in less protected sectors, both because these sectors are more attractive to MNEs and because of the presumed competitive spur of lower protection.

As in most other countries, MNEs have played a key role in the automotive industry in Thailand. Thailand has emerged the Southeast Asian leader in the industry, thus quickly building up a strong export-oriented supplier base. The literature on FDI in China generally concludes that it has been beneficial for growth. This has occurred through the usual channels: augmenting investment, connecting firms in China to global markets (very important for a country which hitherto had experienced several decades of international commercial isolation), and facilitating a rapid transition from uneconomic SOE-dominated heavy industry investments.

Speed of Technology Transfer

Malaysia was one of the earlier countries to attract the MNE-dominated export-oriented electronics industry. FDI impacts have been positive. However, it is alleged that MNEs have undertaken little research and development (R&D), have remained largely confined to the export zone enclaves, and much of the local content is in reality intra-MNE. But the evidence suggests that, over time, MNEs began to put down local roots, particularly as supply-side capacities improved. By the 1990s, the country was quickly losing its comparative advantage in labor-intensive activities, although the Government sought to prolong this advantage by opening up the labor market. From a low base, expenditure on R&D has been increasing rapidly, and is now approximately 0.5 per cent of GDP (compared with 3.0 per cent in Korea). MNEs are shedding low-skill activities, and shifting to higher-value segments. Although the Government will arguably have to be more activist in developing supply-side capacities, Malaysia's experience with FDI and electronics has clearly been more successful than with the auto industry, where a highly protected monopoly has achieved few of the original technology and export objectives.

Not all investments by MNEs lead to technology transfer and positive spillovers. In their desire to protect the technology of the parent company, MNEs may limit the production of affiliates in host countries to low value-added activities, thereby reducing the scope for technical change and technological learning. MNEs may also restrict vertical integration by relying completely on foreign suppliers for their inputs.

In this context, policy makers are concerned that MNEs may be reluctant to undertake local R&D. In Thailand, for example, foreign firms appear to undertake less R&D than local firms. Similar concerns are voiced in India. The explanation presumably is that much of the R&D carried out by MNEs is embodied in their investments and staffing, and thus is not formally recorded in local (host country) R&D statistics. Moreover, the international evidence is that the R&D activities of MNEs are being internationalized, but quite slowly, and that they remain typically heavily concentrated in their headquarters (Dunning 1998). Where these activities do go abroad, they are likely to go to countries whose R&D human capital is internationally cost-competitive (e.g., India or the Russian Federation), or whose governments offer generous fiscal incentives for such activities (e.g., Singapore).

There is finally the question of the extent to which host economies may "leverage" the MNE presence. In an open economy context, two main factors appear to be significant. One is the propensity of MNEs to establish deep local roots, which in turn is determined by the nature of the host economy's commercial and policy environment. The second is whether, and how, an activist approach to tapping the MNE presence may achieve success through emulation, local R&D programs, and advanced training facilities.

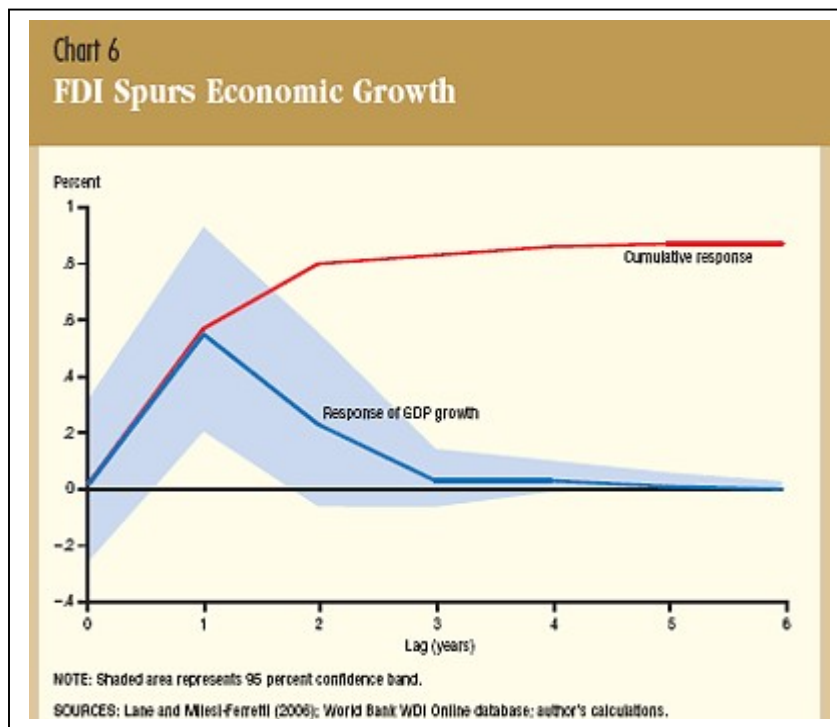
FDI, Growth, and Employment

Increased trade and foreign direct investment could boost economic growth and could be a significant source of employment. Studies have found a strong causal link between foreign direct investment and economic growth. FDI may have a positive impact on growth, but only if the country has a threshold level of human capital. This seems to confirm FDI's important role in propelling growth in China and India, which have vast, untapped technical workforce.

FDI's impact on growth can be the cause as well as the result of economic vitality because foreign capital has the tendency to be attracted to the world's most rapid growing emerging market economies.

FDI inflows are encouraged by sound macro-economic policies and transparent stable economic systems, liberalization of trade, and investment regimes, particularly by liberal FDI policies. Flows are facilitated by full currency convertibility, free repatriation, less performance criteria, tax holidays and other incentives, abolition/ reduction of screening requirements, relaxation of sectoral limits on foreign equity and the dismantling of other policy instruments - which in the view of the foreign investor are investor unfriendly.

There is a significant link between FDI and GDP growth. (**Chart-4**)



In addition to spurring growth, FDI may have wage and productivity spillovers in the host country. If multinationals pay more than domestic firms, it may serve to compel the latter to raise wages. If foreign investors transfer technology to domestic firms, FDI would also help boost efficiency, productivity and overall economic growth.

Regarding employment, the impacts also vary according to the motivation of FDI. Efficiency-seeking FDI may raise many questions from a home-economy perspective. Even if it leads to a greater demand for higher skills at home, this may be of limited use to workers with low skills. Other kinds of FDI appear to have positive employment effects in the long run, depending considerably on the motivations of firms and their types of investments abroad. Evidence related to some Asian economies, such as Hong Kong China and Singapore, suggests that, under appropriate conditions, outward FDI can generate additional jobs in higher-skilled technical and managerial categories while reducing those in unskilled ones.

On balance, in those economies, the job-creating effects of outward FDI exceeded its job-reducing effects. Much would depend, however, on the capacities of the human resources in the home country to adapt to changes in the structure of the home economy.

Conclusions

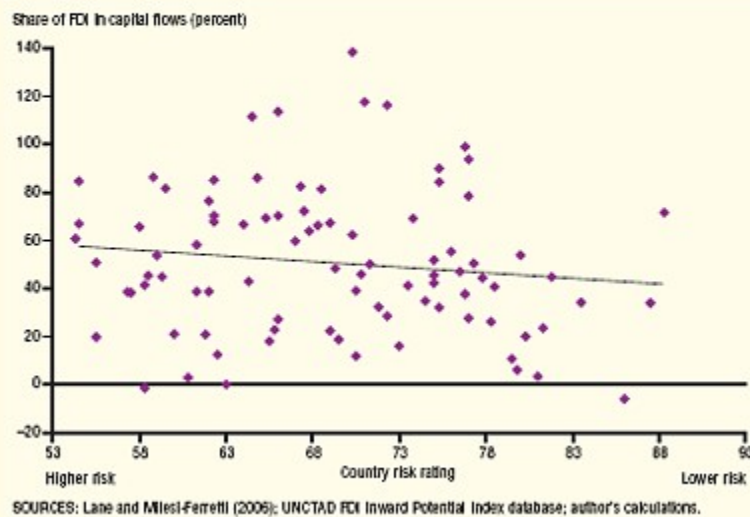
FDI offers attractive benefits that include technology, investments, savings and growth and employment generation. However, there are also some problems that are associated with the flow of FDI. FDI may flow to riskier destinations. This can be seen by plotting FDI's share of a country's total capital inflows against that nation's composite risk rating for developing and emerging countries in December 2003. **(Chart5)**

The downward-sloping line indicates that FDI tends to make up a greater share of capital inflow in places investors might otherwise avoid. Most likely, such countries pay a premium for FDI through tax breaks and other incentives.

During the time of crises, capital flight cannot be ruled out. In times of extreme financial crisis, FDI may be accompanied by distress sales of domestic assets, which could be harmful. Even in normal times, FDI can be reversed or diminished through domestic borrowing by affiliates of multinational corporations and repatriation of funds.

Chart 7

Riskier Countries Tend to Attract Higher FDI



Too much FDI may not be beneficial. Through ownership and control of domestic companies, foreign firms learn more about the host country's productivity, and they could over invest, at the expense of domestic producers. The "crowding out" effect of domestic firms is one possible scenario. There is a possibility that the most solid firms will be financed through FDI, leaving domestic investors stuck with low-productivity firms. Such "adverse selection" is not the best economic outcome.

Despite these pitfalls, FDI appears to help emerging economies develop. It complements the host country's institutions and human capital. In many countries, however, barriers to FDI remain. These barriers may range from limits on foreign ownership and control to outright bans on FDI in select sectors, such as services. Reducing them may well be a way to speed up economic development. FDI benefits investors, to be sure, but it also pays dividends to the countries that attract it. One policy solution to avoid the "crowding out" effect would be to incorporate, as a policy tool targets for FDI- such as the ratio of FDI to domestic investments in any given year- as is the case in Malaysia.

Policymakers in countries at all levels of development need to pay greater attention to the emergence of new sources of FDI with a view to maximizing the development impact of this recent phenomenon. There is scope for policymakers from developing and transition economies to share their experience in this area. South-South cooperation between host and home countries may enhance opportunities for cross-border investments and contribute to their mutual development. From a South-North perspective, there is a similar need for dialogue, increased awareness and

understanding of the factors that drive FDI from the South and of their potential impacts. UNCTAD and other international organizations can play an important role in this context by providing analysis, technical assistance and, not least, forums for an exchange of views and experiences, in order to help countries realize the full benefit of the rise of FDI from developing and transition economies.

FDI flows are likely to grow stronger in the coming years. In addition, another significant factor that may drive the overseas investments in future is the outcome of the WTO negotiations on General Agreement on Trade in Services (GATS) as services sectors today account for 65 per cent of global output, 40 per cent of global FDI stock, 60 per cent of global FDI flows, 30 per cent of global employment and 25 per cent of global trade.

As a result of the Doha Development Round and the Hong Kong China Ministerial Conference decision, developing countries such as India may have to provide duty-free and quota-free access to the products of the least developed countries (LDCs). In that situation, LDCs like Bangladesh may use their cheap labor to enhance textiles production and intensify competition for Indian producers. This might compel Indian manufacturers to shift their manufacturing bases to such LDCs and then export their output back to the Indian markets.

Chapter 4: The nexus between International Trade, Development and Finance: Selected WTO agreements – an insight from the perspective of Asian and Pacific countries

International Trade as an Engine for Development

Recent studies have devoted much attention to trade issues- in particular, the nexus between trade, development and the costs and benefits likely to accrue to developing countries that liberalize their trade regimes under the umbrella of the WTO. Since the conclusion of the Uruguay Round in 1994, a growing number of economic studies have emphasized that developing countries would benefit more from better access to export markets and from reforming their own trade policies than from increases in aid. Evidence from a variety of sources (cross-country and panel growth regressions, industry- and firm-level research, and case studies) suggests that trade is an engine of growth, and that growth is necessary for poverty reduction.

The expansion of trade has played a dynamic role in the growth of the global economy since World War II. Trade surplus is the single most important external source of development financing. Trade liberalization has become a fashionable concept in the

developing world, particularly in the past two decades. This has been associated with rapid growth in a number of formerly poor countries, especially in Asia. Meaningful trade liberalization is an important element in the sustainable development strategy of a country. Increased trade and foreign direct investment could boost economic growth and could be a significant source of employment. Countries with export-oriented policies have, in general, grown faster than those with inward-oriented policies that block integration and discourage competition. And the increase in per capita incomes in these countries has been accompanied by a dramatic decline in the incidence of poverty.

Economists have long observed that countries and regions that are linked by common institutions, currencies, or policies, and that enjoy relatively free access to each other's markets, tend to converge to similar levels of income over time. Between 1960 and 1982, for example, the incomes of poorer regions or countries converged to those of richer ones at a rate of about 2 percent a year in the United States and different parts of Europe and among members of the Organization for Economic Cooperation and Development. Indeed, poorer countries and regions have, in general, grown faster than their richer neighbors with which they have close ties.

It is plausible that trade openness—the extent to which nationals and foreigners can trade with each other without artificial constraints (such as tariffs and quotas)—has played a role in the convergence process by facilitating specialization and promoting competition and the transfer of knowledge.

But it has also been observed that countries that trade widely tend to have good institutions and macroeconomic policies, triggering a chicken-and-egg debate about which comes first. Do the good institutions and policies that are associated with trade play a more important role than the latter in stimulating growth? Does trade stimulate growth or vice versa? Last, but not least important, does growth that is driven by trade raise the poor's living standards or does it increase income inequality, making the poor poorer and the rich richer?

Inadequate availability of foreign exchange as a barrier to the development process has been recognized at least for four decades. Both the domestic savings barrier and BOP barrier were considered as important by the early development economists. There has not been much change in the ground realities during this intervening period, as in many developing countries; access to foreign exchange in line with developmental needs continues to be a problem. There are many reasons why the developing countries could not expand their exports sufficiently as well as why there have been very large differences in cross country experiences

Export -Financed Imports in Asia Pacific Developing Countries

Imports can be financed in several ways, e.g. export of goods and services, FDI, credits, loans and grants. Exports are an important mean of financing imports in many countries. It has been observed that in the process of trade liberation, export earning is the only sustainable source of financing. Higher is the proportion of imports financed through export earnings, greater is the ability of a country to maintain its import requirements.

In a recent study, UNCTAD has found the import-sensitivity of most developing and LDCs to be very high. High income elasticity of demand for imports in these countries is significant to facilitate the early stage of industrialization. They are import dependent not only for their consumption goods needs, such as fuel or food but also developmental imports, such as capital goods required for investments. High import sensitivity is reflected in the import/export ratios but also relate to the structure of the national economy and the composition of imports. The key issue is the dependence on imports for the effective utilization of domestic productive resources that would result in increased exports.. However, if there is underutilization, and which, continues in the short-to-medium term- if not longer (particularly where investment activity is also highly import-dependent), the country will be driven to production levels that are well below potential.

Apart from the development dimension, for some countries availability of foreign exchange is critical simply for survival as these are dependent upon food imports. Most of these are LDCs and some of them are in the Asia-Pacific region. **Table 3** provides some relevant data.

Table 3. Food Imports in Selected LDCs

Country	Commercial food imports% total merchandise imports	Commercial food imports as % of total merchandise exports
Afghanistan	13.4	66.6
Bangladesh	12.2	18.6
Bhutan	6.4	9.8
Cambodia	7.5	13.9
Kiribati	213	127.0
Lao PDR	4.2	7.6
Maldives	12.4	64.1
Myanmar	6.1	11.8
Nepal	8.4	23.7
Tuvalu	13.9	346.1

Source: UNCTAD. The LDC Report 2004.

Data reveal a high degree of variations on the proportion of total export earnings spent on food imports, the proportion being very high for a few.. As a consequence, whenever there are shortfalls in export earnings, there can be pressure on the country's ability to maintain food imports.

Role of Exports in Financing Imports

Developing countries are still largely dependent on imports of capital and intermediate goods for their production processes. It is, therefore, clear that it is necessary for them to make all out efforts to raise their export earnings to be able to sustain a level of imports to support their economic growth. It is observed that most developing countries in the Asia-Pacific region have made commendable progress in this regard. **See Table 4.**

Table 4: Export/Import: Per cent shares

Country	1990	2002
Bangladesh	52	75
Cambodia	62	87
China	123	111
India	78	92
Indonesia	106	125
Iran	88	114
Korea South	96	104
Lao PDR	48	85
Malaysia	103	118
Myanmar	53	92
Nepal	51	81
Pakistan	67	97
Philippines	81	98
Sri -Lanka	77	84
Thailand	81	111

Source: World Bank (2004) World Development Indicators

It may be instructive to look at the export performance of developing Asia in this context. The aggregate performance of the developing countries has been good, basically due to the performance of China, Hong Kong, China, Korea, Rep of, Singapore and Chinese Taipei. At a disaggregated level, it is observed that of 144 developing countries, 54 countries recorded an export growth above the global average growth rate of 6.4 per cent during the 1990s. In developing Asia, 21 of 40 countries fell in this category.

A number of cross-country and panel regressions that have attempted to disentangle the effects of different factors on growth rates and to establish the direction of causality have found evidence that trade openness is strongly linked to faster economic growth. This holds true whether openness is measured in terms of a country's trade policies (tariff and nontariff barriers) or as an outcome (the ratio of exports plus imports to GDP). The relationship is even stronger when purchasing-power-parity GDP is substituted for absolute GDP, thereby eliminating the effect of cross-country differences in the prices of nontraded goods.

Nonetheless, case studies support the argument that trade liberalization raises growth rates. Although opening up to trade does not guarantee faster growth, all of the countries that have taken off economically in the past 20 years have included trade opening in their reform packages. Two seminal studies in 1978 analyzed the phases through which liberalizing countries moved as they shifted from import substitution to outward-oriented trade policies (that is, policies without an anti-export bias). The studies described how the distortions caused by various protectionist measures worked their way through the economy in mostly unplanned and undesirable ways and showed how exports and growth responded to substantial trade liberalization and appropriate macroeconomic policies.

A World Bank study that analyzed the design, implementation, and outcome of 36 trade liberalization episodes in 19 countries between 1946 and 1986 found that strong and sustained liberalization episodes resulted in rapid growth of exports and real GDP.

A study carried out in 1999 found that among relatively closed economies, the poorest in 1960 also grew the slowest between 1960 and 1985, but that low initial income was not correlated with slower subsequent growth in open economies. In closed economies, low initial income reduces potential benefits from scale economies, but trade openness, by allowing access to broader markets, overcomes this problem. More recent microeconomic studies have documented several channels through which openness leads to higher productivity, including the import of machinery and equipment, which is usually accompanied by the transfer of know-how. Other studies have shown that import competition lowers margins and increases turnover and innovation.

Trade is a Complement to Other Reforms.

Much of the evidence about the effect of openness on growth is vulnerable to the criticism that the effect of openness has not been isolated from the effects of a good institutional environment or other reforms that were often implemented at the same time. In case studies and before-after comparisons, for example, the effects of trade liberalization are hard to disentangle from the effects of macroeconomic stabilization, internal price liberalization, changes in the foreign exchange system and the exchange

rate, liberalization of the capital account, reform of social safety nets, and a host of other measures.

In interpreting the role of trade reform as distinct from other aspects of policy, it is important to distinguish between preconditions, desirable complements, and beneficial reform spillovers.

There are few preconditions- reforms in the absence of which trade openness is a poor idea- and there are a variety of reasons why trade openness might promote other reforms. Openness provides powerful channels for feedback on the effect of various policies on productivity and growth. For example, competition with foreign firms can expose inefficient industrial policies. It increases the marginal product of complementary reforms, in that better infrastructure, telephones, roads, and ports enable the export sector to perform better, and it raises the productivity of companies making products for the domestic market as well. In addition, trade liberalization may change the political reform dynamic by creating constituencies for further reform.

Growth reduces poverty. From 1978 to 1998, the proportion of extremely poor people in the world- those living on less than two dollars a day- fell sharply, from 38 per cent to 19 per cent. Because of population growth, the drop in the absolute number of poor was smaller but no less dramatic- from 1.4 billion to 1 billion. This decline is believed to be attributable almost entirely to growth, rather than to changes in the distribution of income.

The histories of China and India provide support for this finding. Between 1980 and 1992, per capita income in China grew 3.6 per cent a year, while income disparities increased significantly (China's Gini coefficient increased from 0.32 to 0.38). Nonetheless, the number of people living on less than two dollars a day decreased by some 250 million, as rapid income growth swamped the effect of the increase in inequality. Income inequality would have had to increase more than twice as fast as it did to undo the effects of strong growth. Similarly, the incidence of poverty in India fell dramatically, from 35 per cent of the population in 1987/88 to 23 per cent in 1999/2000, and it would have fallen to 21 per cent in the 1990s had growth been entirely proportional to income; yet, as in China, the decline in absolute poverty was accompanied by an increase in income inequality.

On the question of whether growth fueled by trade benefits the poor more or less than it does other social groups, no clear pattern emerges from the numerous studies of individual liberalization episodes. This is not surprising: liberalization can change relative prices and incentives throughout an economy. A few generalizations can nonetheless be made. Trade liberalization tends to reduce monopoly rents and the value of connections to bureaucratic and political power. In developing countries, it may increase the relative wage of low-skilled workers. Poor consumers benefit from the lower prices that often follow trade liberalization. Liberalization of agricultural trade typically has the strongest

effects on the poor- both positive and negative- since most poor people in developing countries are engaged in small-scale agricultural activities. But again, the overall benefits of growth for poverty reduction dominate the distributional impact. It is useful to recall that the same holds true for growth triggered by technical innovation- and that there has been little serious argument in favor of halting technical progress on the grounds that its benefits may initially be distributed unequally.

But, until the Uruguay Round of trade negotiations began in 1986, multilateral trade deals tended to be limited to the industrial countries. While developing countries benefited significantly from the growth in global trade, they were rarely active participants in the bargaining process.

This had changed by 1994, when the Uruguay Round, the most comprehensive multilateral trade negotiation in history, was completed, and the WTO succeeded the GATT. The more advanced developing countries had accepted trade-opening obligations in exchange for fuller access to industrial country markets, while the poorer developing countries had agreed to adopt, over time, the same nondiscriminatory rules followed by the major trading nations.

The WTO represents a paradigm shift from the GATT system which was primarily about negotiating market access for traded goods. The WTO is much more intrusive in areas which are critical to the development process. This shift can be detected through the five following areas:

- The extension of the global trading regime into new substantive areas including services, investment, and intellectual property
- More intrusiveness into all areas of domestic policy formulation
- The 'single undertaking' mandate which compels member governments to accept agreements as a package
- The linking of trade explicitly with the protection of both investment and intellectual property rights
- The strict enforcement of disputes and cross-retaliation

A number of important issues remained unresolved, however. WTO trade negotiations to address the Uruguay Round's unfinished business were launched in Qatar in 2001. The so-called Doha Round- also known as the Doha Development Agenda because of the high priority attached to developing country interests- encompasses manufacturing, agriculture, and services; calls for the tightening of trading rules and special provisions and assistance for developing countries; and addresses problems with the implementation of certain Uruguay Round commitments. But participants are having difficulty reaching agreements on key issues- particularly the dismantling of industrial country protection for agriculture. Agriculture has been so contentious that it has eclipsed trade in manufactures and services, two areas that are also important for many developing countries. The scope for industrial countries to strike mutually beneficial bargains with each other is shrinking. Attention in the WTO is increasingly shifting

toward trade between industrial and large developing countries, as the latter use their relatively closed markets for services, capital, and manufacturing as bargaining chips in negotiating for greater access to industrial markets for agriculture and labor-intensive manufactures and services.

The stakes are different for the smaller, less developed countries. Under preferential agreements, many now enjoy virtually unimpeded access to certain industrial country markets. They are leery of multilateral trade liberalization because of concerns about adjustment costs, food security, and the loss of export markets to more competitive countries. They also fear that increasingly complex trading rules might be expensive to implement and therefore hamper their ability to pursue development policies. However, there is large untapped potential in more open trade among developing countries.

Several new developments have taken place since the Uruguay Round which are of equal importance. However, these are not structural but policy-induced.

Due to the commitments taken under the Uruguay Round, under the obligations of the Structural Adjustment Program, as well as unilateral liberalization, the degree of openness of developing countries have substantially increased. While in some cases, benefits in terms of high export growth have been achieved, it is also observed that the susceptibility of these economies to the global economic fluctuations has also increased. Absence of strong domestic competency in managing domestic economic policies in the face of such exogenous shocks has created a new set of problems.

Developing countries almost invariably invoice their trade in one of the reserve currencies, principally the US Dollar. They have absolutely no control on how the USD would behave in the international market but they are instantly impacted by the rise and fall of the US Dollar. In the absence of a developed foreign exchange market with risk management instruments, exporters in the developing countries are perpetually at risk. Of course, one could argue that all exporters face this same risk. While this is true, the depth and variations of any fall out from violent fluctuations in the performance of the Dollar would be more seriously felt by exporters from developing countries.

Similarly global oil and other key commodity prices are determined by a large number of factors. Most developing countries do not influence them but nonetheless get impacted. Even when there may be domestic stability in a country, instability can come through imported inflation which in turn jeopardizes export competitiveness. The conclusion appears to be that with the current stage of economic integration -and the expected increase if the Doha Round negotiations are concluded and the agreed reforms implemented- the developing countries have a strong stake on the stability of the global trading and financial system because of the asymmetry that they get impacted by the instability, although they may not be the primary cause of the instability.

The post 9/11 security environment has brought in its wake a plethora of new rules and documentary requirements. The US has put in place a comprehensive system of checks with regard to imported foods as well as the overseas establishments exporting these to the US under various Acts, such as the Bioterrorism Act and rules such as 24 Hour Advance Informance Rule. Arguably, while these new security measures can be justified under Article XXI of the GATT and Article XIV of the GATS, they are putting additional administrative costs resulting in profit squeeze. Since many exporters of food products are small enterprises, they find the emerging regulatory system both irksome and costly.

In the Uruguay Round, the developing countries were persuaded to accept substantial market access commitments as well as TRIPS in lieu of liberalization in agricultural trade, textiles & clothing and movement of natural persons under the GATS. Empirical studies estimated large global gains of US\$ 213 to US\$ 510 billion a year, with developing countries benefiting to the tune of US\$86 to US\$122 billion. Experiences since then have not justified the initial expectations. On the other hand, newer forms of protectionism have emerged in which most developing countries are finding difficult to cope up with.

Reforming the Governance of the Global Trading Regime

Given that the WTO is a relatively young, one-country, one-vote, member-driven organization with a majority of developing country members, it should present unique opportunities for these countries as well as the potential for serious economic governance reform. But there is need of reforming governance of the global trading regime. Some of these areas are:

Agriculture

Agriculture is linked to human development directly through food security and indirectly through greater agricultural productivity and market access. Developing countries are at a disadvantage in relation to industrial countries as a result of the following:

- The agriculture sector is much more liberalized in developing countries, partially as a result of conditions imposed by the structural adjustment programs of international financial institutions. Developing countries have little if any capacity to provide agricultural subsidies. Significant market failures and other institutional differences increase the challenge for developing countries to shift from subsistence to commercial crop production. Although average tariffs on industrial goods fell from 40 per cent to 4 per cent between 1945 and 1995, agricultural tariffs still average 62 per cent. Agricultural subsidies by OECD members total approximately US\$1 billion per day- six times what they currently spend on development assistance. There is a need to rectify the imbalances between developing and industrial countries in the following ways :-

- Greater policy flexibility for developing countries such as through the expansion of the measures permissible under the “ Green Box” and include a new safeguard mechanism that could be availed of by all developing countries and LDCs.
- Greater market access with a focus on reductions in domestic support and export subsidies.

Commodities

Developing countries have suffered losses of commodity market share (except fuels). Between 1970-72 and 1998-99, the share of world commodity exports declined for example in Africa from 8.6 to 2.6 per cent; ACP countries from 8.4 to 2.4 percent and the LDCs from 4.7 to 1.0 per cent. There is a pressing need for the Doha trade negotiations to seriously address the problems facing commodity exports which have so far been excluded from multilateral trade agreements- especially given their direct effects on human development, particularly for the poorest countries and people.

Trade Related Aspects of IPRs

The Doha Ministerial Declaration was an important milestone for a more public health-friendly interpretation of TRIPS by explicitly recognizing that intellectual property rights (IPRs) should be subordinated to public health concerns. However, the existing mutual bargaining framework is not suited to intellectual property rights, because low-income countries have little to bargain with. . To make it more development oriented there is need to include following:

- Alternative mechanisms for protecting intellectual property rights that do not involve trade sanctions.
- Interpretation and implementation of the TRIPS agreement in a more development friendly manner.

Trade Related Investment Measures

The trade related investment measures (TRIMs) agreement can have a negative effect on employment and value added (e.g. automobile and electronics industries) because of its prohibition of the domestic content performance requirement. There is need to address following concerns of developing countries.

- The prohibition of the use of domestic content performance requirements should be rolled back.
- If this is not possible, the concerns of developing countries should be addressed through special and differential treatment.

- Discussion on investment in the WTO should be guided by lessons from the implementation of the TRIMs agreement.

General Agreement on Trade and Services

International trade in commercial services has seen a tremendous increase from US\$400 billion in 1985 to US\$1.35 trillion in 1999, making up almost one quarter of global trade in goods, most of it in industrialized countries. Because of the political pressures created by the 'request-offer' modality- even though GATS follows a 'positive list' approach, which means no country is bound to offer any sector for liberalization that it does not wish to- basic social services (e.g. water, health, education, and social protection) should be excluded from the requirement of progressive liberalization. There is an urgent need for new concrete measures and timeframes for improving commitments on the temporary movement of natural persons, especially unskilled workers.

Differential Commitments and Obligations by Developing Countries

- Exemptions from disciplines: The most general and fundamental way in which developing countries continue to be exempted from the WTO disciplines regarding market access is the recognition of the principle of non-reciprocity in trade negotiations with developed countries with respect to reduction or removal of tariffs and other barriers to trade. In this regard, there is the urgent need to amend GATT Article XXIV (on Regional Trading Arrangements) to include the principle of non- reciprocity. This issue comes to the fore as developing countries and LDCs increasingly engage in many regional trading initiatives- bilateral and plurilateral in nature. Besides, the impending Economic Partnership Agreements (EPAs) which the EU proposes to conclude with the ACP countries wherein, after an initial transitional period, these poor countries would have to provide market access to the goods and services of the EU would be an erosion of the cardinal principle of non-reciprocity.
- Protection to domestic industry: A second way in which developing countries have greater flexibility in providing protection to domestic industry is through the provisions of General Agreement on Tariffs and Trade (GATT) Article XVIII, which gives developing countries freedom to grant tariff protection required for the establishment of a particular industry. However, this Article is indeed a "dead letter" in the WTO, and availing of this provision would require the approval of all WTO Members by consensus. While the Doha Declaration contains a ministerial decision instructing the General Council to consider ways and means to activate this provision- for use by the LDCs, even if the

negotiations were to conclude successfully, it can be foreseen that its use would be limited in scope and coverage.

- Time extension: The most common way to provide Special and Differential Treatment(S&DT) is through the provision of extension in the time frame over which certain obligations under the agreements are to be implemented by developing countries.
- Experience reveals that there are elements of “reverse S&DT” – special opt-outs and exemptions that benefit interest groups in developed countries at the expense of developing countries. Agriculture subsidy programs, textile import quotas (now removed), tariff peaks and escalations that imply high rates of effective protection for developed countries are examples. Another instance of “reverse S&DT” is in the area of export credit for use by the industrial sector. While the WTO Agreement on Subsidies and Countervailing Measures outlaws the use of such facilities- as prohibited subsidies- industrial country Members who are members of the OECD are allowed to use such credit- as allowed for under the OECD.
- S&DT shall be made mandatory and legally binding through the dispute settlement system of the WTO (including notification requirements and inclusion of these commitments in country schedules).
- Main differences between developed and developing countries are not in trade policies that they should pursue, but in the capacities of their institutions to pursue them. This means that S&DT provisions related to technical and financial assistance, as well as longer transition periods (which are linked to institutional reforms and capacity building) should be emphasized.
- There is a need to promote greater policy coherence between S&DT provisions in the WTO and other international initiatives and organizations. Incoherence in global economic policy-making, where the flexibility allowed through S&DT is practically denied or proactively discouraged, (under the standard structural adjustment programs, which the international financial institutions recommend to developing countries that seek their monetary and development assistance), or curtailed under bilateral or regional treaties and other arrangements between developed and developing countries.
- There should be adequate resources with relevant international organizations, including the WTO, to ensure the compliance with and enforcement of S&DT provisions. Developing countries should have the necessary resources provided to them, to facilitate the utilization of S&DT.

Chapter 5: Trade, Financial Flows, Macroeconomic Policies and Development in a Globalizing Economy- The Coherence of International Trade and Financial Policies.

Financing Development through Trade and Financial Flows: The changing international policy framework

The evolution of flows of finance to developing countries can be seen in the context of the integration of the international financial system and of the global economy. It is therefore pertinent to outline briefly some of the key aspects of the evolution of this system.

The experience of the Great Depression of the 1930s led to co-operation and coordination among countries on financial and trade matters which were crucial in avoiding the destructive protectionism and competitive devaluations of the inter-war period.

The IMF and the World Bank were made responsible for ensuring a smooth functioning world payments system, to provide public funds to help lead the reconstruction of the war-ravaged economies and assist development. To perform the task of ensuring a smooth functioning world payments system, a regime of fixed exchange rates was introduced, with the IMF keeping vigil over these. The gold standard had of course been abandoned, but world currencies under the fixed exchange regime were still tied to gold. The US dollar, whose fixed parity of US\$ 36 to one ounce of gold was crucial to the regime, became the principal medium of international exchange and store of value. However, in 1971, an era of freely fluctuating exchange rates was ushered.

This development had profound consequences for the functioning of both industrial and developing economies. The goal of maintaining stable exchange rates had constrained domestic macroeconomic management to keeping the balance of payments viable. Flexible exchange rates - which directly or indirectly were related to higher inflation, the higher price of oil following the OPEC action in 1973-1974, increasing international liquidity, and greater independence of countries in the exercise of macroeconomic policy -- paved the way for the liberalization of capital markets and the removal of controls over capital movements in the industrial countries.

As private external financing became more prominent, capital controls were gradually dismantled in the advanced countries such that today there are virtually no controls on capital movements as far as the industrial countries are concerned and exchange rates are generally free to fluctuate. Many developing countries have also liberalized their capital markets, often quite prematurely, in order to attract foreign direct and portfolio investment. With exchange rates unstable and no effective controls on capital flows,

countries have found it difficult to manage their economies and prevent financial crises from occurring.

These developments were the result of policy changes, which are premised on the principle that freely functioning markets lead to greater efficiency, higher economic growth and the achievement of social and economic goals. This orthodoxy - advocating conservative, anti-inflationary macroeconomic policy, market liberalization, deregulation, and privatization - took hold first in major economies of the North. Subsequently, these orthodox policies have been imposed by the Bretton Woods institutions on the countries that have sought their help (mainly the developing countries), the availability of official finance being made contingent on their efforts to undertake such measures. These have been embraced, with varying degrees of enthusiasm, by an increasing number of developing countries.

There have been other strong pressures on the countries of the South to open up their economies and integrate more fully into the world economy. These include parallel efforts vigorously pursued in the WTO to engage developing countries in negotiations to establish global rules and disciplines to extend and "lock in" liberalization in a wide range of trade and trade-related matters.

This substantial policy shift has had several consequences for the developing countries. Expanding exports has become a central goal of developing country strategies for raising output and accelerating economic growth. Countries have viewed the inflow of FDI and portfolio investment as a reward for their pro-market and pro-private sector policies.

A major preoccupation of policymakers is to retain international competitiveness, whether by means of exchange rate adjustments or productivity increases. The competition among the newly industrializing countries, which export broadly similar manufactured products, to capture a share of the world market has become intense. This has meant a fall in the prices of their exports and a decline in their terms of trade.

In industrial countries, on the other hand, a strong body of opinion has emerged that maintains that developing countries' success in selling goods in their markets reflects the unfair advantage that developing countries enjoy on account of their low environmental and labor standards. These views - however groundless or exaggerated - feed the protectionist sentiments and lobbies in the North and the pressures exerted by the industrial countries on developing countries to further open up and liberalize their markets.

The corollary to these developments is that, with increasing openness and having to adopt/ adept existing policies to be consistent with the rules and disciplines of multilateral institutions such as the WTO, developing countries' room for maneuver in macroeconomic and financial policy has become severely constrained. A deceleration in the growth of their export earnings is immediately viewed by foreign investors as a sign

of economic weakness, as happened in the case of the East Asian economies financial crisis.

A slight deviation of the exchange rate or interest rate from market expectations can cause "a run" on the currency and financial instability. Moreover, governments as a matter of course feel constrained to take into consideration the judgment of the financial markets as to what are considered as "responsible" fiscal and social policies. With regard to fiscal policy, this usually means a market preference for low revenue/low expenditure budgets, which may make it extremely difficult for countries to achieve their socio-economic objectives.

Policies to liberalize trade and finance and achieve greater integration into the world economy continue to prevail despite the fact that in many countries such policies have yet to be proven correct in stimulating or accelerating economic growth, while they have caused income distribution to worsen in both industrial and developing countries. A significant feature of this shift has been that the new policies tend to favor capital over labor, a reversal from the post-war commitment to full employment and the rise of the welfare state. Some of the strains that one observes in the global economy, therefore, have their origins in this policy shift.

More Integrated Financial and Capital Markets

Increasingly, countries are opening their capital markets but its pace has been slower than for trade- even among the more homogeneous developed economies. Many countries both in developed, developing and LDCs still maintain some restrictions on capital flows but the volume of financial flows has increased both in gross and net terms.

FDI tends to be less volatile than other capital flows and has other potential externalities such as embodied technology, has risen both globally and in developing countries. From a low initial level of US\$22 billion in 1990, FDI toward developing countries is currently running at about US\$200 billion a year, some 2.5 percent of developing country GDP. Developing countries currently attract about one-third of total global inward FDI, as FDI into developed countries is running at some US\$400 billion a year after peaking at over US\$1,300 billion in 2000 at the end of the dot-com boom. Total private financing of developing countries was nearly US\$1,000 billion in 2004, over five times the amount in 1990. The aggregate numbers however fail to show the wide diversity across developing countries- both in terms of levels (and as shares of GDP) and externalities. For example, FDI in natural resource sectors does not necessarily have the employment and technological impact compared with FDI in the electronics sector. A more recent phenomenon has been the increase in outward FDI from developing countries from a low base of about US\$2.2 billion in 1990 to US\$41.1 billion in 2004 (World Bank 2006b).

The improved response to the surge in capital flows has been supported by the adoption of more flexible exchange rate regimes and a monetary policy framework that favors price stability. Inflation has fallen dramatically in virtually all developing countries, from a median of 11 per cent in the mid-1990s to a median of 4.5 per cent during 2002–5. At the same time, the greater autonomy in monetary policy afforded by more flexible exchange rates has allowed authorities to lower local interest rates. Flexible exchange rates and lower interest rates have drastically reduced the incentive to resort to short-term external borrowing, a major vulnerability that contributed to the financial crises of the 1990s. Governments also have taken steps to accelerate development of domestic capital markets (especially local bond markets) to create more diversified financial markets that would be more capable of handling volatile flows in portfolio capital. These developments, along with the shift from debt finance to equity (particularly FDI), have contributed to the marked improvement in developing countries' net external liability position. The ratio of external debt to GNI for developing countries as a whole fell from a peak of 44 per cent in 1999 to about 34 per cent in 2004, while since the mid-1990s short-term debt has declined in most developing countries relative to long-term debt and foreign exchange reserves.

There has been progress in simplifying capital controls and exchange rate restrictions imposed by many countries. But the gradual opening of capital accounts must be accompanied by a further strengthening of macroeconomic policies, the development of local capital markets and the institutions needed to regulate them, and the establishment of a system of risk management robust enough to respond to the needs of a more flexible exchange rate and open capital account. This is often referred to as “sequencing” the opening up of capital accounts. Liberalization of the capital account once implemented is difficult to reverse. A return to capital controls should be seen only as a policy of last resort, to be used to dampen excessive exchange rate volatility or to moderate large inflows of capital when other policies, such as interest rates and intervention in foreign exchange markets, prove fruitless.

The global financial system is likely to change dramatically over the course of the next 25 years, as technological innovations and even greater integration of markets expand the reach of global financial intermediaries. For instance, the increasing clout of hedge funds necessitates some form of global rules, given that these type of funds presently account for about 40 per cent of trading in some stock markets; and banks—pillars of the financial system increasingly depend on hedge funds for much of their revenue.

Some of these changes are impossible to anticipate. For example, it is not clear whether the future communications technologies will favor a continued concentration of financial intermediation, or encourage the growth of global banks and other financial institutions in a wide range of markets, or lead to even greater decentralization as smaller investments are required to obtain the information necessary to carry out financial transactions. Other changes can be partially anticipated. For example, as developing countries take up a greater share of global output, it is likely that their

importance in financial markets will continue to grow. Some decline is already apparent in the dominance of the dollar as a currency of lending and reserves (World Bank 2006b), but whether currencies from developing countries will play a major role in global financial markets is not yet apparent.

One major issue facing developing countries over the next quarter-century is the impact of demographic trends on the countries' access to external savings. The rise in old-age dependency ratios in industrial countries, and in some developing countries, is likely to be associated with a decline in saving, a rise in interest rates, and a fall in their current account surplus.

All else being equal, the elderly tend to save less or even dissave, as they live off of savings earned during their working years. While forecasts of saving rates are uncertain, and estimations of the relationship between aging and saving rates vary widely, the prospect of reduced global saving over the coming decades needs to be considered seriously.

Trade Integration Will Accelerate

The trade dimension of globalization has currently become more integrated with financial and capital markets. This integration has perhaps been the most prominent, especially with the emergence of Asia and the transition economies over the last two decades. Growth in trade has outpaced growth in output by a factor of two or more and the causes behind this phenomenon are in place to sustain it over the next two decades.

Income growth, changing comparative advantage, and the push toward greater openness will continue to lead to expanding global trade over the next two decades. Though import tariffs have dropped dramatically since 1980, they still remain stubbornly high in some sectors, for example in agriculture and services, in some countries. Protection can also take other forms, for example antidumping, and questionable standards.

Progress in opening markets has stalled at the multilateral level, but countries continue to pursue liberalization either unilaterally or through bilateral and regional agreements. While the standard theory of trade has focused on comparative advantage, new trade theory places much more emphasis on the role of specialization. Specialization is manifested in two ways. The first is consumers' desire for greater varieties of the same categories of goods. Whereas 25 years ago consumers had a relatively modest selection of automobiles or fashion, today's range of consumer goods is huge. This love of variety has provided producers from a diverse set of countries with opportunities to export. A second form of specialization is represented by production networks that allow for the breaking up of the production process across multiple firms and/or countries. The

growth in production networks has been predicated on many technological advances- both physical, as in telecommunications and transport, and management processes, such as supply chain logistics. This has been further facilitated by more integration in capital and financial markets. In these economies, imports have increased tremendously and these have been financed by export growths. FDI in some cases is also successful in creating more capacity to produce as well as to enhance export-orientations.

There is little evidence that these factors will subside anytime soon. Under the central scenario, the level of exports would more than triple- from about US\$9 trillion in 2005 to over US\$27 trillion in 2030- with a concomitant rise in the world export-to-output ratio, jumping to 34 per cent from 25 per cent currently. For developing countries, exports will increase from about US\$3 trillion to over US\$12 trillion, reflecting in part these countries' greater output growth. These baseline numbers are predicated on the assumption of no change to current trade policies. Under a broad reform scenario whereby all countries reduce tariffs on merchandise goods (and domestic agricultural protection) by three-quarters, exports by developing countries would increase by an additional US\$2 trillion in 2030, a jump of some 18 per cent over the baseline.

Some Key Concerns of the Developing Countries and LDCs

Since the Monterrey International Conference on Financing for Development (the so-called " Monterrey Consensus") was held in March 2002, the range, complexity and urgency of the issues facing developing countries and LDCs have increased.

Notwithstanding recent upward patterns in increased inflow of FDI into developing countries and - to some selected LDCs, inadequate and uneven level of capital flows both official and private for financing development remains a major concern. Although flows in aggregate terms comprised a higher percentage of capital inflows to developing countries it has suffered from important deficiencies regarding their level, composition and distribution.

This matter continues to be a crucial issue. The large majority of developing countries, particularly LDCs with low incomes and limited export earnings, continue to need concessional flows to supplement their domestic capital accumulation and for sustaining their development efforts. Added to the inadequate level are the conditionalities attached to these bilateral and multilateral official flows of development finance and the stiff competition for these capital flows from countries with economies in transition.

The continuing long term fall in real commodity prices faced by some developing countries and LDCs has drastically reduced the resources available to these countries for

their development efforts and it has been partly responsible for the growing debt problems of many LDCs. The international initiatives put in place earlier to deal with fluctuations in commodity prices and to assist developing countries to deal with this financing shortfall have not provided a satisfactory solution. The prospects for a substantial change in this situation are not optimistic, taking into account current trends in commodity prices. For more than a decade now, the need to service the debt owed by LDCs to bilateral aid agencies and multilateral financial institutions has diminished in critical ways the finance available for development. Debt servicing has seriously eroded attempts to improve the well-being and productive capacity of large segments of the population, as a result of the decline in output and cuts in public expenditures on health, nutrition, and education.

Of particular concern among LDCs countries have been the broad economic policy prescriptions they have been required to pursue by the multilateral financial institutions in exchange for debt relief and financial assistance. These policies in most cases have done little to enhance their growth and development or their capacity to repay their debt. This has given developing countries added reason for dissatisfaction over their lack of weight and influence in the governance and policy-making of the multilateral financial institutions, including in decisions concerning the structural adjustment and similar policies prescribed for them to follow.

It has been argued by some that these development financing problems would become less as private capital became available to developing countries. While international flows of private capital have increased very considerably in recent years, the bulk of such flows go to the advanced industrial countries, and of those going to the developing world most are concentrated in a few countries which have particular attractions from the investors' point of view.

Working on the assumption that a greater degree of private capital inflows was the solution to the problems associated with the lack of domestic resources to finance their economic development, many developing countries have pursued a number of measures to facilitate or attract such inflows. Experience, however, has demonstrated the potentially harmful macro-economic implications of unregulated private flows, particularly short term flows. As such, there is a growing chorus of views which call for careful domestic policies regarding the content, level and sequencing of private capital inflows, as also the need for international policies and regulations regarding capital flows- which aim both to minimize the likelihood of financial crises occurring, and to provide appropriate means to deal with them, if and when they occur.

As a result of the profound impact of the financial crisis on the economies and societies of East Asia and its global reverberations, there is now a greater awareness of the need to reconsider various aspects of international financial flows and the international financial architecture. These issues are as much political as economic and constitute an important dimension of North-South relations. Any new, comprehensive approach to

financing development and a structuring of appropriate global institutions will need to embrace measures which help to reduce the marked imbalance of power between the developed and developing countries and give greater voice to the developing countries and the LDCs.

Another factor is the adoption of policies of economic liberalization that has increased the exposure of developing countries and LDCs to external economic forces, over which they have little control, making macroeconomic management much more difficult. Their commitments to the IMF and the WTO has further narrowed the scope for policy choices. While the international economy is vulnerable to the vagaries of international financial flows and world market developments, developing countries are particularly vulnerable. The East Asian crisis has driven home the point that this vulnerability does not disappear with the rise of robust export industries, impressive gains in living standards, and overall sound economic management. The developing countries have witnessed their vulnerabilities increase, and their political and economic independence compromised, as they opened up their capital accounts and deregulated their capital markets.

Trade and Development

Trade can be a powerful source of economic growth. But while broadly based economic growth is necessary for economic development, it is not sufficient. Economic development also requires enlarging people's choices and opportunities-especially poor people's. Liberalizing trade does not ensure poverty reduction, nor does it guarantee immediate economic growth. Current experiences of emerging economies reveal that it is largely determined by internal and external institutional and social pre-conditions. The nature of resource allocation and social inclusion - especially for poor and those participating in the informal sector - are important determinants of growth leading to development.

Trade and Growth

Trade and growth should be seen as means to development rather than ends in themselves. To achieve this, there must be appropriate macro-economic and sectoral policies that foster and deepen forward and backward linkages economy-wide, national policies that identify supply side constraints and which address such constraints, enhance national competitiveness including through the promotion of product and process technologies, human resources development, employment creation and income distribution and which promote sustainable development. The experiences of emerging economies reveal that economic growth can contribute to development in two ways:

- Employment-led growth raises household income - which can reduce poverty and lead to development
- Growth can increase government revenue - which can contribute to economic development if used to pursue policies aimed at reducing income and asset inequality and health and education enhancement

Cross-country analysis also shows that openness in policies in some cases of emerging economies particularly through international trade may expand markets, facilitate competition and disseminate knowledge, creating opportunities for growth, poverty reduction and human development. Trade can also raise productivity and increase exposure to new technologies, which often spurs growth. Nevertheless, cross-national comparisons reveal no systematic relationship between countries' average levels of tariffs and non-tariff barriers and their subsequent economic growth. In Asia, Vietnam the Republic of Korea, PR China and India are cases in point which illustrates that trade, especially import liberalization is not a prerequisite for sustained economic growth. Since the mid-1980s, Vietnam has taken a gradual approach to economic reform, whilst maintaining a significant level of state trading, import monopolies, quantitative restrictions and high tariffs(30-50%) on agricultural and industrial imports. Yet the country has achieved GDP growth of more than 6 per cent per annum for a sustained period, sharply reduced poverty, expanded trade, attracted considerable foreign investment and (despite high trade barriers) is rapidly integrating with the global economy.

The experiences of China and India also reveal similar results. Chinese and Indian trade restrictions are amongst the highest in the world. Increase in China's growth started in the late 1970s. Trade liberalization started only when the growth rate increased substantially - in the second half of the 1980s and the 1990s. India's growth rate increased substantially in the early 1980s. Trade reform started in 1991 – 1993. Tariffs were higher in the high growth period of the 1980s than in the low growth 1970s. It is therefore not obvious that further liberalization is in all countries' interests. But open trade requires a set of global rules, universally applied, that promote greater freedom for global market actors. The Indian and Chinese experiences suggest that a gradual, sequenced approach is beneficial, and that import and trade liberalization is not necessarily the highest development priority.

Arguments have also been forwarded that LDCs stand to benefit from trade liberalization on the grounds that greater trade reduces poverty and freely functioning markets lead to greater efficiency, higher economic growth and the achievement of social and economic goals. On the contrary, LDCs experiences hitherto have not proved this: Poverty is increasing in the LDCs with both open and closed trade regimes. But between these extremes, poverty is increasing in countries that have liberalized trade more. LDCs have also been told to export their way out of poverty. GDP declined or

stagnated in 8 out of 22 LDCs with increased exports. In 10 of these countries, poverty increased. 14 with rising GDP saw poverty fall.

To support trade and market liberalization, deregulation and privatization policies, the Asian Tigers are often presented as examples of countries that predominantly relied on export-led growth. This was only one, and not the most important of their strategies. Other strategies are protection of the domestic market – most of their trade liberalization occurred only after high growth was established in the 1980s. Government also supports local investors through: credit subsidies; tax incentives, education promotion; generous export subsidies; duty-free excess to access and capital goods; extension of credit to large businesses at negative real interest rates. . In Korea, the state bailed out entrepreneurs investing in ‘desirable’ activities if these became non-viable. Public enterprises also enhanced the profitability of private investment by ensuring that key inputs were available for private producers e.g. through a large share of manufacturing output. Other market protected policies include sustained encouragement to domestic firms to reverse engineer foreign-patented products, imposed TRIMS requirements on foreign investors e.g. export-import balance requirements; domestic content requirements.

Conclusions

Based on above experiences it can be said that the only systematic relationship between countries’ economic growth and their trade barriers is that they dismantle trade restrictions as they get richer. Economic integration is an outcome, not a prerequisite to growth and development. Institutional innovations – much unorthodox and requiring policy space – are crucial for success.

Trade is a means to an end, not an end in itself. Trade rules have to allow for diversity in national institutions, development strategies and standards. Countries should have the right to protect their own institutions and development priorities. No country has the right to impose its institutional preferences on others.

- The context in which the current debate on the integration of international capital and financial system with international trade and its impact on financing of economic development are taking place is different from the conditions that prevailed in the period, immediately after World War II with the setting up of the Bretton Woods institutions. One significant difference is that many more countries; including developing and especially LDCs are now involved in the increasingly uniform but more complex world financial and economic system. The establishment of the WTO has also added new dimension. But while the developing and LDCs countries have the same interests in global growth and financial and economic stability as do the advanced industrial countries, they are

also concerned that the policies that govern world financial matters and the nature of the institutions governing world trade, finance and capital should assist rather than hinder their development and impinge on their national sovereignty.

- For the system to serve developing and LDCs countries' needs, a concerted attempt to devise a comprehensive approach to financing development is required, ensuring that adequate and appropriate external finance is available to supplement domestic savings. Even among developing countries, it is important to understand that the development needs of LDCs are completely different and distinct as compared to developing countries. LDCs must be clear on their goals and strategy with respect to their role in various international institutions. Otherwise, there is a risk that these international institutions will focus only on a limited number of issues and preoccupations, often narrow in scope, while giving scant attention to important policy and structural questions and interrelationships which suggest the need to undertake a fundamental rethink and reform of the system itself. The need for reform of the international financial architecture, *inter alia* to end the exclusion of LDCs countries from key areas of international decision-making. For these matters to be considered properly, it is important that the most of international institutions should consider LDCs development issues at the highest policy level and within the framework of the United Nations, the world body entrusted with the mandate to tackle global problems, including economic, political and social ones, in an integrated manner. Unlike in the Bretton Woods Institutions, in the UN the developing countries participate on an equal footing with the developed countries, and are able to speak more freely and to act jointly, and can wield greater political influence.
- The mobilization of domestic resources for development or raising the level of domestic savings is critical. The experiences of many developing countries, particularly those in the East Asian region hitherto is sufficient proof that a high level of domestic savings - coupled with policies that encouraged the productive use of these savings- such as creating an environment conducive for the promotion of domestic investments- provided the base for expansion of the economy.
- One of the factors contributing to falling commodity prices was the policies these countries were constrained to follow under structural adjustment programs set by the multilateral financial institutions. Among other things, they were required to put greater emphasis on production for export to facilitate greater openness in trade, with the result that the output of commodities increased at a time world demand for such products was relatively slack.
- Although the Bretton Woods institutions were originally established with the noble intention of creating a clearly structured and purposeful system of orderly

world payments, developments in international financial markets and the lack of regulations that could discipline or govern these financial flows and sophisticated instruments have resulted in little attention paid to the consistency, or the impact or durability of the arrangements. These factors and the lack of any political will to re-examine the *raison d'état* of these institutions *vis-à-vis* developments in the financial markets has resulted in the current day malaises – which hardly could be referred to as an orderly arrangement meriting the term 'system'.

- Since capital movements at that time were rather restricted, the common cause of balance of payments difficulties was the build-up of domestic inflationary pressures due to excessive demand growth and tightening labor markets. In this situation of "overheating" - as it was then called - a rise in imports, and the concomitant worsening of the trade deficit, provided the relief valve.
- The current surge in private capital flows has occurred in the midst of much-improved domestic policies and global financial conditions compared with those that prevailed during the capital flows surge of the 1990s. This time around, governments have so far generally managed to avoid excessive expansion of aggregate demand, large current-account deficits, and sharp appreciations of the real exchange rate. However, the policy agenda for managing capital flows is broad and complex, and considerable challenges remain.
- Despite the considerable improvement in policies in recent years, the surge in capital flows still presents substantial risks to developing countries. Future risks to economic and financial stability will likely take a different form and character than those encountered in the past -and may expose institutional and macroeconomic weaknesses that cannot be anticipated at this juncture. One warning sign of potential troubles has been the surge in portfolio inflows that has been associated with a dramatic escalation of stock market prices and valuations in many developing countries, particularly in Asia, raising the risk of asset price bubbles.
- Other signs of possible trouble are appreciated exchange rates and current account deficits in some Eastern European countries. The impact of individual risks could be magnified if several were to occur simultaneously.
- The current account in many developing countries, particularly major oil exporters and emerging Asia, has moved from deficit to sizable surplus, intensifying the demand for reserve accumulation. That many of these countries have accumulated foreign exchange reserves far in excess of the level required for intervention and liquidity purposes partly reflects a desire to self-insure against global financial shocks. As the volume of reserves increases, however, so does the importance of balancing their use for intervention, investment, and

insurance purposes against their domestic resource costs. For countries with large holdings of foreign exchange reserves, allowing local institutional investors to diversify their investment portfolio globally- while ensuring their more effective regulation- could provide a viable channel of capital outflow, as well as an opportunity to further diversify risk. This would transfer currency risks, currently concentrated on the books of central banks, to domestic institutional investors with a longer investment horizon and a greater ability to manage such risks. Such an approach is also more desirable for many developing countries than inducing adjustments through the current account as a way of absorbing reserves. In addition to allowing institutional investors greater scope to invest overseas, consideration should be given to enabling local residents to invest in approved international assets, as the Republic of Korea has done.

- Oil-exporting countries face particular challenges in managing volatile export revenues. Although high oil prices are now expected to persist, considerable uncertainty remains, and oil exporters should save a part of the windfall- for example, to reduce debt and make productive physical and social investments. Some countries have put aside a fraction of their oil revenues in a stable portfolio of diversified financial assets (referred to as “funds for the future”), thus reducing the risk of over consumption of oil revenues and the potential for Dutch disease. Such funds require robust governance and legal frameworks to effectively insulate earmarked oil wealth from political decisions guided by short-term agendas. The government must set and adhere to clear objectives for their investment, protection, and eventual use. Countries that depend heavily on oil revenues should also consider using derivatives to reduce the volatility of future income.
- A growing number of developing countries have made considerable efforts to meet international standards for transparency, corporate governance, and the regulation and supervision of financial systems. Although this is a global trend, individual countries take different approaches to adapting international standards to their corporate environment. Some, for example, are issuing codes that set compliance targets in tandem with laws setting minimum compulsory standards, while others are using codes to raise public awareness in advance of upcoming regulatory reform. The adoption of national codes of corporate governance in at least 60 countries by the end of 2005- including all of the Asian crisis countries, plus China, Colombia, Turkey, and Ukraine- underscores the growing recognition of the importance of corporate governance in enhancing investor confidence, a recognition that bolsters the resilience and stability of capital markets globally. Priority must now be given to effectively implementing and enforcing these new domestic policies and institutional re-forms at the national level.

- Developing-country policies must be reinforced by renewed international efforts to promote stability and maintain a financial environment conducive to a balanced expansion and deployment of capital flows in developing countries. One major risk to stability is the growing imbalance in global payments and the associated market anxiety about the possibility of a disorderly adjustment of the imbalance through sudden changes in exchange rates and global interest rates. Such changes could destabilize and disrupt international financial markets, which would cause all countries to suffer. Although a coordinated policy of intervention in foreign currency markets- similar to the Plaza Agreement of September 1985- is neither desirable nor feasible (given the changes in global financial market conditions and actors over the past two decades); a degree of multilateral cooperation is needed to address the current global imbalances. That approach, based on the mutual interests of deficit and surplus countries, should reflect the structural asymmetry between international reserve currencies and other currencies. At its center must be consensus on a blend of ex-change rate and aggregate spending adjustments adequate to rebalance global aggregate demand toward surplus countries without causing a global recession. Ordinarily, policy coordination among key players is unnecessary, because floating exchange rates, accompanying monetary policies (oriented primarily toward domestic targets for inflation and economic activity), and independent central banks do their job to facilitate adjustment to any shocks hitting the world economy. But when the sustainability of the sources of finance for global payment imbalances is in doubt, as it is at present, multilateral cooperation to prevent sudden and disorderly market reactions becomes highly desirable, especially if the growing global imbalances create pressure for protectionist trade policies in some countries. Developing countries, in particular, have much to gain from multilateral cooperation, and much to lose from its absence, and they would suffer disproportionately if instability was induced and a disorderly unwinding of global financial imbalances ensued.
- The world economy is moving toward a multipolar international monetary system in which the monetary and financial policies of the United States, Euro Area, Japan, and several key emerging market economies, including China, all exert substantial influence. Policymakers in emerging market economies should therefore strive to strengthen institutions and promote policies and mechanisms that will improve their ability to navigate in a world of increasingly integrated and interdependent financial and production systems.

Chapter 6: Addressing Global Imbalances: A Development- Oriented Policy Agenda

Issues resulting from the interface between international finance, international trade and economic development have emerged as the pivotal economic factor in contemporary globalization, and a determining element in the national efforts of developing and least developing countries to foster economic and social development. Developing and least developing country policies and macroeconomic outcomes are very much influenced by the actions and policies of the centers of decision-making and economic power of the multilateral institutions, major international banks or investment companies, and / or of the governments of the rich and powerful nations.

The foregoing research has briefly reviewed a number of key issues related to the interface between international finance, trade and economic development and suggest the need for urgent action in a number of areas to address the imbalances created in the development efforts of developing and least-developed countries.

It is evident from recent trends and experiences that trade remains a growth engine for developing countries.

Worldwide, merchandise exports grew by 22.5 per cent in current dollars in 2004, partly due to increasing volume and partly to rising dollar prices, e.g. for oil and other commodities. As for developing countries, they now account for about a third of global trade, and some 40 per cent of all their trade is between themselves. This South-South trade is also growing about three times faster than world trade. China and India, of course, are garnering a large share of this rise in trade, accompanied by soaring GDP. China's average export growth rate rose fairly steadily - barring a few blips - from 12.8 per cent in 1980-90 to 31 per cent in 2003-04. In the same period its GDP has stayed largely on a growth course, climbing from 7.5 per cent in 1980-90 to 9.5 per cent in 2003-04.

Generally strong and rapid growth also characterizes recent flows in foreign direct investment. According to UNCTAD estimates, global FDI inflows in 2005 were up 29 per cent to US\$897 billion, generated by the world's 70,000 transnational corporations (TNCs) and their 690,000 affiliates abroad, employing 57 million people worldwide. Here as well, developing countries are getting a bigger and bigger piece of the pie. FDI inflows to these countries surged to US\$233 billion in 2004, up 40 per cent, and by a further 13 per cent in 2005. South-South investment flows now represent more than a third of all investment flows to the South, where 20,000 TNCs are based.

But not all developing nations are benefiting from this growth. Much of it is concentrated in a handful of countries, with many others becoming increasingly marginalized. Merchandise exports of sub-Saharan Africa, for example, have declined as a percentage of world exports, from 1.6 per cent in 1990 to 1.35 per cent in 2004. The

share of the world's 50 poorest countries - the LDCs - rose minimally over the same period, from 0.56 per cent to 0.64 per cent. The services picture is similarly bleak. These figures are extremely alarming, given the intertwined evils of poverty, economic instability and terrorism.

Analysts have warned about the consequences of the large current account deficit of the United States - which measured a record 5.7 percent of GDP in 2004 - and its matching surpluses in a few countries, mainly in emerging Asia and the oil-exporting countries. Related to this situation is the increasingly lop-sided pattern of economic growth. In recent years, global growth has been, and remains, unduly dependent on the United States and China; performance in the euro area and Japan continues to be inconsistent and disappointing. If this trend persists, it risks widening existing imbalances, and increases the chances of drastic disruptions to world economic growth.

While current account deficits are not undesirable *per se*, experience shows that deficits of the size that the U.S. has been running cannot be sustained indefinitely. That deficit is already being financed by record levels of debt in the hands of foreign investors, and the demand for U.S. assets is not unlimited. Unless policymakers take action to facilitate an orderly resolution of these imbalances and maintain investor confidence, there is a risk that investors will reduce - or even reverse - their exposure to U.S. assets. This could in turn be accompanied by volatility in currency and capital markets, sharp interest rate increases, and disruptions to global economic growth and stability.

However, assuming that trade in fact promotes development and economic growth in much of the developing world, we need to ask why it is that some countries gain more, and others gain less, or even lose, from trade liberalization and globalization. Aside from the sheer comparative advantage of some countries in terms of location, natural resources and so forth, it would appear that trade liberalization has had its costs - and that openness to trade is simply not enough. There have been some optimistic forecasts of tremendous income gains, export revenue gains and new jobs to come from the expiration of the Multifibre Arrangement, for instance. But there have also been some dire predictions of how devastating these same reductions in trade barriers, and removal of preferences, will be for a number of textile-producing nations.

Trade and growth should be seen as means to development rather than ends in themselves. As the research reveals, trade can also raise productivity and increase exposure to new technologies, which often spurs growth. Nevertheless, the research also reveals that cross-national comparisons reveal no systematic relationship between countries' average levels of tariffs and non-tariff barriers and their subsequent economic growth.

Anti-inflationary macroeconomic policies, market liberalization, deregulation, and privatization policies were promoted by the Bretton Woods institutions- and imposed on the countries- that have sought their help (mainly the developing countries), the

availability of official finance being made contingent on their efforts to undertake such measures. But it can be concluded especially in the case of LDCs that trade liberalization does not necessarily promote economic development.

Thus, openness alone is not enough. What else should developing countries do to ensure that liberalization boosts trade and helps them to generate higher income, which is essential to kick-start development and reduce poverty? UNCTAD's Trade and Development Index, introduced in 2005 with the active support of Professor Lawrence Klein, attempts to measure the complex relationship between trade and development in a precise and quantitative manner. It shows that, in addition to trade liberalization measures, other factors are needed to guarantee that openness brings concrete benefits. These include macroeconomic discipline, good governance, infrastructure, skills, institutional capacity and investments in health and education. In effect, this implies that in conjunction with liberalization, developing countries must develop their comparative and competitive advantages and their capacity to deliver goods and services efficiently. They must also diversify and move away in particular from volatile commodity markets. They must increase their share of the global export revenues, move up the value chain by tapping into world distribution networks and create backward linkages from multinational investments to the local economy. Furthermore, they need to reduce their dependence on fossil fuels, especially given the rise in oil prices as well as environmental imperatives.

At the same time, they must aim to attract the right kind of foreign investment and avoid the wrong kind. Investment that brings know-how and transfers technology; investment that creates skills at home and prevents brain drain. The right kind of FDI, in short, creates a virtuous circle: it brings capital and knowledge that stimulate domestic investment (both public and private) in productive capacity, skills and physical infrastructure, thereby building a strong nation. The wrong kind means investment that favors enclave development, where profits tend to be repatriated back to the home country and where there is no value-added or know-how passed onto the local economy, whether in terms of new skills, new industries or new enterprises.

The Doha Round of multilateral trade negotiations intended as the so-called "development round" achieved only very modest progress at the Sixth WTO Ministerial Conference in Hong Kong China (2005). At the point of undertaking this research- and writing its conclusions- the Round remains elusive as the much hyped- about political will has not been translated into concrete and ambitious proposals in agriculture- that embody the "development promises" that would enable negotiators to unlock the current stalemate in the other areas of the negotiations. The Round, according to trade analysts and economists will create ever-greater opportunities for developing countries. Rising trade trends suggest that the multilateral trading system is indeed working.

The delays in concluding the Round are especially frustrating for poor nations, such as the cotton producers in West Africa, who have had their hopes pinned on the multilateral trading system: that it would lift them out of the poverty trap. Brinkmanship- at this late stage of the negotiations- does not help to yield the development dividend.

The inability to reach agreement will affect the credibility of the WTO as an institution. In fact, today the WTO is the only body of law governing multilateral trade relations across a wide spectrum of activities, affecting border measures and other internal economic and trade policies. . The institution and the body of WTO law provide for security and predictability in international trade and investment. It provides for scrutiny of domestic economic and trade policies of its members through its Trade Policies Review Mechanism, and it offers a forum for resolving disputes through the Dispute Settlement Mechanism, in a system that was unified and made binding as a result of the Uruguay Round negotiations. This framework facilitates trade and investment as the foundation for sustainable economic growth, and apart from some further spelling out of rules, none of this will change as a result of the current negotiations, no matter what the outcome.

Regardless of the conclusions of the Round, developing countries will still require help in coping with the ongoing reforms and meeting the costs of adjustment to market openness and globalization. Removing subsidies, barriers and preferential trade terms can be harmful, causing the loss of livelihoods and tariff revenue as well as greater vulnerability for infant industries. International support is thus desperately needed to help poorer economies build their capacity to compete, retrain the workforce, shore up their infrastructure and facilitate trade- if these economies are to more fully gain from the benefits of liberalization, including from the Doha Round. It is also essential that such funding be in addition to current levels of international aid, and that it will not create new debt. In this regard, it is timely that at the Hong Kong Ministerial Conference, "Aid for Trade" was recognized as necessary for facilitating the smooth integration of developing countries into the international trading system. But if aid for trade is to be meaningful, it must be relevant, targeted and adequate and it must be additional to resources currently being made available. As the case with all aid for development, aid for trade should also reflect the priorities of the recipients. It must be demand-driven.

But aid for trade is not a panacea for all trade-related problems. Nor should it substitute for development benefits that must arise from a successful outcome of the Round, as the Hong Kong declaration itself pointed out. It must, rather, complement any such outcome; it must, in short, keep the development promise of the Doha Development Agenda. That means that if it is adequately designed, managed and implemented, it can help developing countries to really use trade and trade liberalization as an engine of development and poverty reduction.

The existing international financial system, such as it is, seems far from serving to promote the adequate or appropriate financing of development of countries at widely differing levels of development. A curious mixture of *laissez-faire* and interventionist approaches has been adopted, leaving individual developing countries to navigate increasingly complex waters as best as they can in search of external financing.

While additional types of external financing have become available, these flows are not available to most developing countries; nor have they reduced or supplanted the need for traditional development finance. But for those developing countries which have received such inflows, they have often brought new problems in their train. Moreover, the continuing failure to deal with developing country debt and low and fluctuating commodity prices and the associated poor terms of trade means that the need of many developing countries for external financing is that much greater.

The result is that many countries, including the poorest, are largely deprived of external financing to supplement domestic savings, while considerably more advanced developing countries which received substantial private flows have been catapulted into financial crisis with enormous economic, social and political consequences. Examples: Africa in the case of the former and the East Asian and some Latin American countries in the case of the latter.

The severity of the economic set-back, the massive and precipitous increase in poverty, and the political and social dislocation resulting from financial crisis in some of the Asian countries has caused even some erstwhile adherents to the "Washington consensus" to seriously question both the appropriateness of key tenets of current orthodoxy concerning free capital flows, as well as key elements of the IMF/developed country policy prescriptions.

There are many reasons, therefore, for arguing that it is now time for efforts to be made at the international level to consider financing development in an integrated manner. While action is required to improve external financing for developing countries and measures are needed which could lessen the need for such flows, action is also required to alter the international policy and institutional framework within which international flows for financing development take place.

From the least developing country perspective, the issues that most warrant immediate attention are:

- Concessional official flows to developing countries have declined over the years, while the list of recipients of assistance has expanded to include economies-in-transition. Official Development Assistance (ODA) has been channeled to many and varied purposes other than capital transfers for long term development, with a large part of what is counted as ODA flows never leaving the donor countries. If these additional uses are subtracted from the total ODA flows, the

South is in fact receiving today only around 0.12 per cent rather than 0.7 per cent of the North's GNP - the stipulated ODA target.

- A number of economies, especially the poorest, face a serious burden of bilateral and multilateral official debt, which is being allowed by the donors to fester like an old wound, sapping debtor countries of capital vital for development, and subjecting them to continuing conditionalities and interference in their national policy making and priorities. Financial crisis has recently aggravated the economic situation of a number of major debtor countries, such that another major debt crisis looms on the horizon.
- Many developing and LDCs have suffered what is in effect a continuing and substantial reverse transfer of resources due to the decline in commodity prices and adverse terms of trade. This has set back their development and added to their problems of indebtedness.
- As far as private flows are concerned, the great majority of developing and LDCs have been bypassed by the recent surge of such capital flows. But it is debatable whether they are necessarily worse off than some of those that have been recipients of private flows but have ended up with financial collapse and economic disruption, from which recovery is likely to be slow.

The financing of development and the question of the international financial architecture cannot, however, simply be viewed as narrow technical matters. The present system must be redesigned so that it is better equipped and geared to achieve the goals of raising general living standards, sustaining economic stability, and promoting full employment in both developing and industrial countries. It must respond to the development objectives and needs of developing countries, many of which have been adopted by the international community and incorporated into the work of the United Nations system.

Some Suggestions for the Way Forward – Research Findings

The research undertaken reveals that the global community has the means, to implement certain measures and act concordantly to contribute to the creation of a system which is efficient, fair and responsive to development needs in the developing countries and LDCs and which would be a significant contribution to improved international cooperation, and thus to world peace and prosperity. These areas are as follows:

- Growth in the Euro area and Japan must be increased, so as to re-establish their leading roles in global economic expansion. Structural reform remains the key to

unleashing the potential of the European and Japanese economies. Policy requirements in the euro area would differ across countries, but in general, there is a need to increase labor utilization, further liberalize product markets, and promote greater financial sector integration. Similarly in Japan, greater improvements are needed in labor market flexibility and product market competition. Additionally, barriers to inward foreign direct investment should be lowered, and agricultural policies liberalized.

- In the United States, credible and sustained measures must be taken towards fiscal consolidation, particularly in the medium-term. This is a key step for maintaining investor confidence in U.S. assets.
- Third, in China and emerging Asia, moving towards greater exchange rate flexibility, and strengthening financial sectors, continue to be priorities. Exchange rate flexibility would also carry the added benefit of greater monetary control for countries. China's vibrant growth has benefited not only the region, but also other parts of the world. A more flexible exchange rate system, together with broad structural reforms in the financial and enterprise sectors, will facilitate China's continued global integration.
- Financial crises have become a frequent and chronic occurrence in the international financial system, ravaging countries and regions and affecting the world economy. To try to reduce the likelihood of crises occurring, it is now time to work towards internationally agreed rules to regulate international financial markets and to permit national policies to control short term capital flows. Similarly, there needs to be a reassessment of the policies to be adopted to manage financial crises should they nevertheless occur. While this is clearly a highly complex matter, such an effort seems indispensable. It is extremely unfortunate that the massive private resource flows to developing economies which, under certain conditions, have contributed to their growth and prosperity, also contributed eventually to financial turmoil and an associated economic crisis from which recovery has always been painful and slow. Not infrequently such crises also give rise to widespread social and political turmoil, which tears apart the social fabric. The issue before the development community is whether the waste and disruption associated with private flows can be avoided and the benefits for development and for host countries maximized.
- In thinking about ways to improve the financing of development, several points need to be considered. First, a careful weighing of the terms, conditions, and magnitude of foreign capital inflows is as important for the more advanced as for the less advanced developing countries. Countries that can better afford borrowing on commercial terms, or are otherwise attractive to foreign private investors, still have to confront the problems of unpredictability and swings in

private capital flows, particularly short term flows, as well as their often dubious development impact. Private short term flows are driven by expected short-term financial returns, which are not necessarily good indicators of the real economic return. A substantial portion of private capital in recent years has gone into portfolio investment, that is, the purchase of existing assets (real estate, stocks, etc.). This does not necessarily generate an increase in the host country's productive capacity, and it can lead to real losses, as well as real gains, to the host country.

- Foreign loans should be invested in areas which generate foreign exchange income and not used simply for consumption. Experience has shown that freely functioning markets alone cannot always ensure that foreign private capital will create productive assets and yield income. Governments have a role in regulating the inflow of foreign capital and to channel it into areas of national priority.
- Experience has also shown that developing countries have been too hasty, and international financial institutions too insistent, in opening up their capital accounts and deregulating their financial sectors. This increases their vulnerability to the swings in the world's capital markets and handicaps them in their pursuit of national development. Membership in the WTO requires opening up capital account and current account convertibility on the grounds that “cross-border movements of capital is an essential part of the (supply of the) service itself” (Footnote 8, Article XVI, The General Agreement on Trade in Services). Thus, for example, management of the exchange rate is particularly difficult with an open capital account; currency depreciation may be required to keep the tradable sectors competitive and appreciation may be necessary to absorb the capital inflows.
- In the current debate on improving the international financial system, much attention is focused on the better monitoring of capital movements, that is, the IMF must have better, more complete, and timely information on all forms of capital movements in developing countries. However, better monitoring alone, or even weak regulation, may not suffice so long as currency markets remain highly unstable. Speculative capital movements are intimately tied with perverse exchange rate movements, and the resolution of one problem is not possible without dealing with the other. Experience has shown that short-term capital movements tend to feed on currency movements: the more a currency appreciates the more it is sought by short-term investors, and vice-versa.
- The large swings in capital movements can be directly related to the deregulation of capital markets in developing countries. The East Asian economies, which were thought to be adept at channeling foreign capital into development activities, fell victim to the fickleness of private foreign flows, as

they opened up their financial markets too far and too fast. However, the case for unfettered international capital movements is far from robust. Some leading economists argue that there is need for better international regulation of capital markets and for individual developing countries themselves to operate controls over short term capital flows, as undertaken already by some developing countries. Great caution therefore needs to be exercised in the opening up of the capital account in developing countries and they should desist proposals for prompt and complete liberalization of their capital accounts.

- The regulation of short-term capital movements will, however, have a bearing also on the pace of liberalization of trade, since in many cases balance of payments difficulties, and the consequent need for external financing, arose out of rapid growth in imports following too rapid an opening up of the economy to foreign trade. In the absence of trade policy interventions, the entire burden of adjustment to reduce the trade deficit falls on exchange rate changes or domestic demand contraction. While the greater regulation of international capital markets can be expected to reduce the incidence of financial crises, as will both domestic measures to regulate capital flows and prudential regulation of the financial sector, other measures will be required to minimize their ill-effects once crises do occur. One important shortcoming of the current international arrangements is the absence in the South of regional intervention facilities and other measures to limit contagion.
- Development assistance and concessional finance continue to be of critical importance for supporting the development of the developing countries and LDCs, and in supporting development-related objectives or activities which are not attractive to private capital or the market. Indeed, massive transfers of resources to the developing world are needed to promote sustainable development, eliminate the causes of poverty, and in general enable the South to participate in and benefit from the global economy. In other words, overcome the development gap.
- Development assistance and concessional finance must therefore be brought to the fore again on the global agenda as a top priority issue. But the approach must be recast to reflect lessons learned, current realities and new global challenges. Development assistance and concessional finance for development should become an entitlement to help developing countries attain a set of internationally agreed development goals and standards. Its provision should become an obligation of the international community, and in particular of the rich industrial countries of the North. Developed countries need to scale up their aid to low-income countries, as pledged in the Monterrey Consensus. Despite rises in recent years, aid levels remain, in real terms, well below those seen in the early 1990s, and also well below the 0.7 per cent of GNP commitment made decades ago.

- Servicing external debt continues to drain massive resources from developing countries, depriving them of resources which otherwise could be used for development purposes. The external debt issue is one of the most disturbing and inequitable features of contemporary North-South relations. Resolving the external debt overhang calls for a global political response based on the need to promote development. Moreover, an agreement establishing the rights of debtor developing countries is needed as an integral part of a comprehensive solution to resolve developing country indebtedness. Greater attention also needs to be paid to promoting a more favorable external environment for developing countries, such that debt and debt servicing do not assume critical proportions.
- The problem of commodity prices continues to thwart the development efforts of many developing countries, in particular the poorest and weakest. Past international policy responses have been inadequate. It is now time for the international community to give serious attention once again to devising mechanisms which would raise commodity prices from their persistently depressed levels and introduce better medium-term balance into commodity markets, while encouraging diversification away from the production of commodities in persistent surplus.
- The future trend in commodity prices will depend heavily, on the demand side, on the rate of economic growth in the main industrial countries, as modified by changes in the "intensity of use" of primary commodities, and demand expansion for imported commodities in industrializing developing economies. On the supply side the most important factor affecting future commodity prices will be the extent to which the recent expansion rate of commodity exports from developing countries will be maintained. The situation does not augur well for commodity prices and commodity exporters. The already low forecasts for the trend rate of growth (significantly below 3 per cent) have had to be adjusted downwards as a result of the pervasive impact of the Asian financial and economic crisis. Moreover, it seems probable that the decline in the intensity of use of primary commodities will continue, partly as a result of the adoption of new technologies now being developed. On the supply side, the extent of future expansion is likely to depend among other things on the degree of pressure exerted on commodity-exporting countries to expand their exports in order to restructure their economies and to meet their debt service obligations. An international agreement to achieve a considerable reduction in debt levels and debt cancellation for the poorest countries would significantly reduce the pressure on developing countries to expand their commodity exports for so long as real commodity prices remain at historically depressed levels.

- Under present circumstances, therefore, the probability is that the underlying trend of depressed levels of commodity prices will continue at least well into the first decade of the 21st century. Thus, it must be assumed that, in the absence of remedial action, commodity prices will continue to have an adverse impact on the economies of commodity-dependent countries. There are many such countries and many of them are among the poorest. This situation is inefficient and inequitable. The debt burden of most developing countries is high in relation to their export incomes, resulting in continuing pressure to expand exports for the purpose of fulfilling their foreign debt service obligations. Commodity export supply therefore tends to react to changes in the debt situation rather than to changes in world commodity prices, which means that a "low-income trap" is created for many developing countries: depressed export prices are a major element in the rise in debt, while the higher debt requires an increased supply of commodities to be exported to raise foreign currency needed to service the debt, a process which further intensifies the depressive forces on world commodity markets. At the same time, there is a huge misallocation of resources involved in subsidizing high-cost agricultural production in the OECD countries, rather than importing competitive agricultural products from low-cost producers, whether developed or developing. Developing country commodity producers therefore bear a disproportionately high share of the real costs of adjustment to changes in world supply and demand of commodities. Leaving international commodity markets to free market forces cannot be expected to deal with the underlying problem of the downward trend in real prices of commodities exported by developing countries. Moreover, the free play of market forces is likely to exaggerate the scarcity/glut cycle characteristic of many commodity markets, which underlies the swings in commodity prices. Past efforts to deal with these problems through international action have not been effective and by the 1990s there was no effective market stabilizing mechanism in place. The UNCTAD Integrated Program for Commodities (IPC), approved in 1976, which differed from the earlier commodity-by-commodity agreements, was beset by a number of difficulties, including the lack of enthusiasm for such mechanisms. Furthermore, both the IMF and the European Community schemes have failed to provide more than very marginal compensation. It is therefore urgent to search for an effective international strategy for strengthening the commodity sector of developing countries. Alternative approaches advocated in recent years by the World Bank and supported by the governments of a number of developed countries involve the management of commodity price risks through commodity-linked financial instruments. The use of forward contracts and other commodity-linked financial instruments can substantially reduce the commercial risk of certain individual commodity exporters, particularly those who are large and have expert knowledge and finance available. But there are clearly limitations to the widespread use of such instruments in developing and least developing countries for many years to come. Moreover, although the use

of financial instruments may reduce individual commercial risks, it will not by itself reduce price instability in the commodity markets. The usefulness of hedging on the financial markets does not, therefore, obviate the need for renewed efforts to establish price-stabilizing mechanisms of the sort envisaged by the Integrated Program for Commodities combined with a compensatory finance scheme. These would need to be accompanied by measures to resolve the longer term causes of depressed levels of prices, namely chronic excess supply, involving concerted efforts to help diversify the economies of producing countries away from commodities.

- Developing and least countries need more trade, in order to generate the kind of sustained and rapid growth that is needed for meaningful poverty reduction and human development and meeting the MDGs. Accordingly, developed countries have to go beyond providing aid, and make determined efforts to open up their markets to exports from developing countries. Likewise, developing countries also need to remove their trade barriers. Further multilateral trade liberalization, including through a completion of the WTO's Doha Round, will also bring sizeable benefits. For example, by some estimates, freeing up merchandise trade and removing all agricultural subsidies could generate gains of up to US\$280 billion by 2015, with a high share of these gains going to developing countries. According to recent research by IMF staff, more open economies are better able to withstand higher levels of volatility with less adverse effects on growth.
- In the area of multilateral trade obligations however, an appropriate provision should be incorporated that would allow any Member of the WTO that is seriously affected by a financial crisis(such as that which affected East Asia) to temporarily deviate from its legal obligations under the WTO, subject of course to strict caveats and monitoring by the Organization.
- The industrial countries had been pursuing in OECD the objective of concluding an international agreement on foreign investment, known as the Multilateral Agreement on Investment. This was intended to ensure rights and guarantees for investors, even though it is not evident that the current arrangements are inadequate. It seems doubtful that foreign investors, 90 per cent of which are multinationals of the North, are in need of protection. However, no consideration was given to the responsibilities and obligations of foreign investors and home countries. The negotiations in OECD, which have been suspended, represent an example of pursuing "corporate welfare" and have proven to be controversial not only in the developing countries, but also in the industrial countries. However, efforts by the North to achieve an international agreement on foreign investment are not likely to be abandoned, and will continue to be pursued within the WTO – where it was suspended over the objections from the majority of developing countries and LDCs .

- The need to manage FDIs to ensure that such investments more fully benefit the host country and its peoples. This, of course runs contrary to the general assumption that, while external debt needs to be managed carefully, FDIs do not need any regulation: investors seek profits and they themselves will pay for the their mistakes. Even if this were true, there are often economic and social costs of these mistakes to be borne by the host country. For example, the experience of countries which aggressively sought FDI for infrastructure projects shows a high incidence of irregularities and corruption. Furthermore, certain of the financial factors that have contributed to the recent financial crises in East Asia- and indeed aggravation of the external indebtedness of the countries involved- are intimately linked with foreign direct investment. Owners of foreign direct investments, for example, often engage in other financial transactions such as local borrowing and hedging which can be highly volatile and contribute to financial instability and crisis.
- The need to include a provision that provides the right to the host country of FDIs to prevent, albeit even temporarily, the free expatriation of profits and capital to their home countries when the host country is faced with balance of payments problems- without having to obtain the permission of the IMF *a priori*.
- Thus there is a case for instituting a normative and legal framework, and a system of incentives and disincentives, to ensure that foreign capital actually serves the development needs of the recipient countries. There was, some time ago, extensive discussion within the United Nations on the development of a "code of conduct" for multinational corporations. This was an attempt to define the rights and obligations of foreign investors. However, no agreement could be reached as multinational corporations strongly resisted attempts to impose any code of conduct on them, and the matter was shelved in 1988. In the light of the serious economic disruption in East Asia, and the prospect of foreign investors taking unfair advantage of the current, temporarily collapsed values of productive assets, the time seems opportune for the world community to make another attempt at developing an international framework intended to ensure that foreign investors are more socially responsible and development oriented. This would benefit both industrial and developing countries. Similarly, there is also the need for some form of regulation on the practice of hedging. In this regard, the leadership of Germany, as the current Presidency of the EU in steadfastly pursuing this for the EU countries, even if it only results in a voluntary code is a step in the right direction.
- Measures are urgently required to end the marginalization of developing countries from decision-taking and policy-making in the multilateral financial institutions and to make the latter accountable and responsive to the entire community of nations. Democratization is a maxim very much in vogue. The

international financial institutions have not, however, espoused such a belief when it comes to their own governance and continue to be governed by a powerful few. Hence, the rules and functioning of the international financial system reflect the interests and preferences of those who dominate the institutions. It is therefore crucially necessary to devise means to make the multilateral financial institutions genuinely open to participation by, and fully accountable to, the entire global constituency. The present practice of critical decisions having a substantial bearing on national policies being almost entirely made by the Secretariat of these international financial institutions (such as the IMF) and imposed on developing countries and the LDCs needs to be urgently revisited and revamped. A more participatory mode- such as that practiced in the WTO, notwithstanding the shortcomings of decision making by consensus- needs to be studied.

- There still remains the question of finding adequate sources of concessional finance. Given the often parochial politics of the national budget process in industrial countries, there is likely to be continued resistance to agreeing increases in development assistance transfers from countries of the North to the South. Attention therefore needs to be devoted to devising *additional* revenue-raising measures to fund concessional financing and involving new relationships based on new foundations. Flows and transfers derived from the globalizing world economy, and belonging to the international community as a whole, therefore also merit special attention. These should not, however, be considered as a substitute for national contributions of concessional financing from the developed countries of the North.
- Developing mechanisms in certain important global policy areas while at the same time generating revenue on an automatic basis for financing development. These mechanisms include the idea of introducing some version of the so-called Tobin tax on short-term, speculative capital movements which, in addition to generating income, has the advantage of discouraging destabilizing short-term capital movements. There have been several other ideas on obligatory, international levies to generate revenue, which need also to be considered.
- Coordinated and determined effort to correct the current global imbalances with less disruption to international economic stability. The IMF, WTO, World Bank and other international institutions should also be ready to facilitate an orderly adjustment of the imbalances, including by helping to coordinate the various policy measures required. The maintenance of economic stability is a vital ingredient for continued economic growth worldwide. Both stability and growth, in turn, are critical elements in the fight against global poverty. Foreign investors have become key actors in the global economy. Considerable effort has been devoted both in the North and in the South to facilitating their

activities and acquiescing to their policy demands. The extensive influence of foreign investors, particularly of large multinationals, in developing countries and in global development suggest that it is necessary to introduce a degree of balance and to spell out investors' duties and obligations. Thus, attention needs to be devoted at the international level to developing a normative and legal framework to regulate the behavior of foreign investors. Foreign direct investment can contribute a great deal by providing not only physical capital, but also the transfer of technology and more efficient business practices. In particular, it has been observed that where foreign direct investment has been carefully and purpose fully managed by the host country, as in some East Asian countries, it can make a considerable and strategic contribution to national development.

- Low-income countries themselves need to intensify their efforts in economic and other reforms, including through further development of their own poverty reduction strategies. These strategies should continue to focus on sound economic policies and good governance.

Research Conclusions

The world economy is moving toward a multipolar international monetary system in which the monetary and financial policies of the United States, Euro Area, Japan, and several key emerging market economies, including China, all exert substantial influence. Policymakers in emerging market economies should therefore strive to strengthen institutions and promote policies and mechanisms that will improve their ability to navigate in a world of increasingly integrated and interdependent financial and production systems.

Financial liberalization is inevitable for countries for achieving- higher investment, faster growth, and rising living standards by integrating in the open world economic system in today's age of modern information and communications technologies. But crisis in Asia, in Russia, and in Latin America have again demonstrated, however, financial liberalization also has its dangers.

Critics of open capital markets, on the other hand, point to the inefficiencies resulting from adverse selection, moral hazard, and herding behavior, all of which are byproducts of asymmetric information- a situation in which not all parties to a transaction have equal information. Government policies, however, can lessen or mitigate the potential damage from asymmetric information problems. A fixed exchange rate, which pegs the value of a currency to a strong foreign currency like the dollar or the Euro, has many advantages, particularly for developing countries seeking to build confidence in their economic policies. And such pegs have been associated with lower inflation rates.

However, countries with fixed exchange rates seem to be more vulnerable to currency crises, as well as to twin currency and banking crises, than those with more flexible regimes. Indeed, as economies mature and become more closely tied with international financial markets, the benefits of exchange rate flexibility appear to increase.(David Cheney, based on IMF Working Paper 04/126,“From Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility,” by Rupa Duttagupta, Gilda Fernandez, and Cem Karacadag.)

Developing-country policies must be reinforced by renewed international efforts to promote stability and maintain a financial environment conducive to a balanced expansion and deployment of capital flows in developing countries. One major risk to stability is the growing imbalance in global payments and the associated market anxiety about the possibility of a disorderly adjustment of the imbalance through sudden changes in exchange rates and global interest rates. Such changes could destabilize and disrupt international financial markets, which would cause all countries to suffer.

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