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INTERNATIONAL ECONOMIC INTEGRATION AND DOMESTIC FINANCIAL POLICY

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## INTERNATIONAL ECONOMIC INTEGRATION AND DOMESTIC FINANCIAL POLICY

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The politicians and economists who created the post-World War II economy aimed to restore the global economy that existed in 1913 and that was destroyed by two world wars and the Great Depression. They succeeded beyond any sober expectation. International trade has grown faster than output throughout the post-World War II period: by 1973, after two decades of unprecedented growth and prosperity, the ratio of trade to output was above its 1913 level, and the share of trade in GNP has continued to grow since then.<sup>2</sup> Major national money, bond, and stock markets are now as integrated as they were in the pre-capital control pre-World War I period. However, capital flows to developing countries declined sharply during the last decade and foreign direct investment is still relatively less important today than it was a century ago.<sup>3</sup>

There are many reasons to hope that the trend of increasing international integration will continue in the last decade of the century:

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<sup>2</sup>This statement is based on data for 32 countries (including developing countries in Asia and Latin America) in Maddison (1989). For these countries the ratio of exports to GDP was 10.5% in 1913, 6.3% in 1950, and 11.7% in 1973. The 1986 ratio is 13%.

<sup>3</sup>Maddison (1989), Chapter 2, estimates that the ratio of foreign-owned capital in developing countries to world GNP was about 10% in 1900 and 6% in 1985. Certainly, no major foreign creditor today comes close to the British position in 1914, when foreign assets amounted to 125% of GNP.

Eastern Europe and the Soviet Union are, hesitatingly, rejoining the international economy; European integration proceeds rapidly; and the Uruguay Round could open up trade in services and perhaps even agriculture and textiles. But there are also grounds for pessimism. Financial institutions are failing in the U.S. on a scale not seen since the Great Depression, and financial fraud and lawlessness is widespread. The structural transformation of Eastern Europe will take longer and be more difficult than expected, and the future economic course of the Soviet Union is highly uncertain. Political instability in Eastern Europe and the Soviet Union is already evident. The Uruguay Round negotiations failed to reach agreement by the appointed date at the end of 1990, and their final outcome too is uncertain. Fear of fortress Europe looks more valid after the December 1990 negotiations in Brussels; the development of separate regional trading blocs -- Europe, the Americas, and East Asia -- is a real, rather than a bargaining, threat.

I address three sets of issues in this paper. Even though the theme of the conference is financial leadership, the first topic I take up is the Uruguay Round negotiations, and questions arising from the potential development of regional trading blocs. Should we fear or welcome the possible division of the world into two or three major trading blocs? I start with the integration of goods rather than financial markets, because a breakdown of the multilateral trading system would have major implications for international and domestic financial markets. Second, I will raise a set of questions about the global integration of capital markets -- which, incidentally, through the discussion of trade in

services, is also an issue in the Uruguay Round. A major question here is the Feldstein-Horioka puzzle: why, despite the openness of capital markets, are domestic saving and investment so highly correlated? Does this mean that international capital flows make little real difference to the international allocation of resources? Third, what does the increasing integration of financial markets imply for individual economies? Is financial liberalization primarily a source of potential problems, including the Dutch disease and destabilizing short-term capital flows, or does it bring real benefits to well-managed economies? Most important, what domestic financial policies should developing countries pursue to take advantage of the changing global possibilities?

I. The Uruguay Round.

The volume of world trade has grown by 1.5-2% per annum more rapidly than real output over most of the post-World War II period.<sup>4</sup> The volume of trade between developing and industrialized countries expanded far more rapidly than overall trade -- especially in manufactures, and especially from the NIEs and the near NIEs of East and South-East Asia. The superior export performance of the East Asian economies is strong evidence for the view that trade serves as the engine of growth, though, as implied by Table 1, Latin America grew fast for some time while pursuing a trade-reducing import substitution strategy. The potential failure of the

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<sup>4</sup>In the 1980s, world trade increased at 4.5% per annum while world output grew 2.8% per annum on average.

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 Table 1: Growth of GNP and Exports, 1965-1989 (% p.a.)  
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	Export Growth	GNP Growth
SubSaharan Africa	3.5	3.2
East Asia	10.0	7.2
South Asia	3.7	4.2
Latin America and Caribbean	2.4	4.3
OECD	6.1	3.2

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Source: World Bank, World Development Report 1991.

Uruguay Round raises concerns that, at least, trade growth would cease serving as an engine of growth, and, at worst, that trade restrictions would serve as an engine of destruction.

The Uruguay Round negotiations address an extremely ambitious agenda that goes well beyond the goal of cutting tariffs. Post-Tokyo Round explicit industrial country tariffs on finished and semifinished manufactures average less than 10% (Table 2), and tariffs on raw materials

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 Table 2: Industrial Country Tariffs, Post-Tokyo Round\*  
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	Average on imports from all countries	Average on imports from developing countries
E.C.	6.6	5.8
Japan	6.4	6.7
U.S.A.	6.6	6.7

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\* Percentage tariff on finished and semifinished manufactures.

Source: World Bank, World Development Report, 1987, p.136.

are even lower. The period since the Tokyo Round has been characterized by the growing use of non-tariff barriers, including voluntary export restraints (VERs), to the point that nearly one quarter of industrialized

country imports are subject to NTBs.<sup>5</sup> Because the restrictiveness of NTBs varies, the percentage of imports covered by NTBs is a poor measure of their impact; research on measuring the tariff equivalent of NTBs is proceeding. Nonetheless, both the extent and rising trend of NTB coverage convey the same message as less quantitative impressions.

We should not exaggerate though. Trade did continue to expand in the 1980s. Trade in manufactures has been the engine of growth for many economies, and others too can benefit from integrating into the world economy. The fear is less over what has happened so far than over what could happen if current trends -- including those to regional trading arrangements -- continue. The Uruguay Round was launched both to reverse current trends by revitalizing multilateral trade and by dealing with non-tariff barriers, and to extend the benefits of open trade to other commodities, especially agricultural commodities and services.

The issues are being discussed in fifteen negotiating groups, including those on tariff reductions,<sup>6</sup> nontariff measures, textiles and clothing, tropical products, dispute settlement, safeguards, subsidies, anti-dumpings procedures, and the functioning of the GATT system (FOGS).<sup>7</sup> Attention has focussed on the most ambitious new areas, intellectual property rights, services, and agriculture. Protection of intellectual property provides an incentive to produce new ideas and inventions.

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<sup>5</sup>For data on NTBs, taken from UNCTAD, see United Nations, World Economic Survey, 1990, p.67. During the 1980s, the extent of NTB coverage is shown as rising from 19.4% to 23.4%.

<sup>6</sup>Agreement was reached at the mid-term review of the Uruguay Round to cut tariffs by one third.

<sup>7</sup>The IMF's World Economic Outlook, October 1990, Supplementary Note 3, summarizes the issues in and structure of the Uruguay Round negotiations.

However there is no reason to think that it is optimal for a developing country to extend the same level of protection (for example, the life of a patent) to an invention as is optimal for an industrialized economy. In calculating the optimal degree of protection to give to intellectual property in its domestic market, a developing country should consider not only the incentives it provides for domestic inventors, but also the incentives it gives to foreigners to invent appropriate technology for its domestic markets.<sup>8</sup>

Trade in services, especially financial services including banking and insurance, has been highly protected, in both industrialized and developing countries. The reasons are many: government reliance on bank finance implies a preference for a captive domestic industry; so does government desire to direct credit -- indeed the old argument that heavy industries represent the commanding heights of the economy has been transferred to the financial system; so does the wish of many governments to control capital movements. However, protected financial institutions, like other protected firms, are likely to be highly inefficient, and foreign competition is likely to benefit domestic residents. Trade in labor services is also being discussed in the Uruguay Round. It is not possible at this stage to predict what if any agreements on services will be reached, but with the production of services accounting for over 50 percent of GNP in advanced economies, the importance of opening up trade in these areas is obvious.

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<sup>8</sup>For a more complete analysis, see Diwan and Rodrik (1991).

Previous trade negotiations have stayed away from agriculture, in part due to a non-economic sense that food sufficiency is a reasonable goal, but more because the domestic politics are too difficult. The issues in agriculture are a textbook example of the politics of protectionism. The cost of agricultural protection to the citizens of the EC has been calculated at \$300 billion, and the total costs to the budgets of the industrialized countries in the mid-eighties reached \$200 billion.<sup>9</sup> The political strength of the agricultural lobbies in each country results not so much from the numbers of farmers, but more from their geographical concentration or their role in particular parties.

The hope in a global negotiation such as the Uruguay Round is that bigger coalitions can be put together to deal with a large number of issues simultaneously and thereby overcome a concentrated local interest. The United States government had in this case proposed measures opposed by many United States farmers. But the Europeans -- whose political calculations are complicated by the central role of agricultural subsidies in the EC budget -- were not willing to deal seriously on agriculture, and Japan was happy to stay in the background. Liberalization of agricultural trade would benefit Eastern Europe and some developing country producers, several of them heavily indebted, and many of them joined in the Cairns Group. The importance of the Cairns Group, which links industrialized and developing countries, extends beyond the role it has played in the agriculture negotiations: for the first time a significant group of developing countries is taking a very active role in the negotiations, pushing the

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<sup>9</sup>The budgetary costs have been significantly reduced since then.

case for freer trade, and abandoning the argument that what the developing countries need is special and differential treatment.

There is no obvious way around the agricultural impasse and Uruguay Round prospects are therefore poor. If the round fails, we can expect increasing non-tariff protection and the further development of regional trading blocs. What do we have to fear from the development of three major trading blocs, the EC, the Americas, and East (or all of) Asia? Europe 1992 is almost upon us, and the fear that it will be a fortress Europe has not been reduced by the December 1990 Brussels negotiations, or their aftermath.<sup>10</sup> EFTA is negotiating with the EC, and other countries in Europe are lining up to join. The United States has reached a free trade agreement with Canada, is likely to reach an agreement with Mexico, and has invited the rest of Latin America to join an American free-trade area. Data on intra-bloc trade is presented in Table 3. The dominant trading bloc by far is the EC; the value of intra-EC trade in 1988 was seven times the value of trade between North America and Asia, which is at the same level as trade between North America and Western Europe.

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 Table 3: Intra-Bloc Trade  
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	Share of world trade (%)		Share of intra-bloc trade in bloc's total trade (%)	
	1980	1988	1980	1988
E.C.	17.8	22.5	53.6	59.8
US-Canada	3.8	5.2	26.7	35.3
Australia-New Zealand	0.1	0.1	6.1	7.6
CMEA	3.9	4.5	50.1	55.7

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Source: United Nations, World Economic Survey, 1990, p.54  
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<sup>10</sup>These suspicions are reinforced by a statement by an EC official "We are not building a Single Market in order to turn it over to hungry foreigners", quoted in Hamilton (1990).

The success of the EC, and trade frictions among other countries, has made regional integration an attractive alternative to the multilateral trading arrangements favored by the GATT and the founders of the post-World War II economy. However, Africa, the Middle East, and Latin America are littered with failed regional trading arrangements, and it is only very recently that Europe moved directly from Eurosclerosis to Europhoria. What determines the benefits from a larger trading area? The traditional theory of customs unions (Lipsey, 1960) draws the distinction between the trade-creating and trade-diverting effects of a union, but reaches no general conclusion that the creation of a union improves the welfare of its members.<sup>11</sup> The presumption is that the more trade is created rather than diverted, the more likely the arrangement is to benefit its members. Economies of scale make gains more likely, as does the impact of greater competition on formerly protected producers, leading to potential dynamic gains from trade. All these benefits would be greater in a free trade world. Nonetheless, it may be that most of the gains from trade are realized by the time very large free trade areas -- for example three worldwide -- are created.

There is as yet no common market or free trade area that includes only the nations of the Asian Pacific. The United States is one of the twelve members of the Asian Pacific Economic Co-Operation Forum (APEC),

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<sup>11</sup>The gains are likely to be larger: if the production structures of the integrating economies are similar, so that they can gain from specialization and because trade diversion would be relatively less important; if external barriers are kept small; and the larger the size of the union (again because trade diversion is relatively less important).

whose goals are to encourage the free flow of trade within the region as well as support multilateralism in international trade. The joint GNP of the APEC countries (nearly 50% of the world total) and their share in world trade (40%) both exceed those of the EC. In recent months there have been attempts to create an East Asian trade group that excludes other Pacific Basin countries, but they are unlikely to succeed in the face of vigorous opposition by the United States.

Why is there nonetheless a fear that the global trading system will devolve into three rather than two trading blocs? The sources of that belief must include: the continuing rapid growth of the Japanese economy; continuing trade frictions between the U.S. and Japan that are seen by many in the United States as the result of Japan's unwillingness to open its economy to trade; increasing links between Japan and the rest of East Asia -- especially through direct investment; and the increasing importance of Tokyo as a financial center. In brief, there is a suspicion that Japan will seek to exert a leadership role by excluding the United States. At the same time, U.S., and especially Congressional, frustration with Japan is leading it to turn inward and to the Americas.

While the growing strength of the Japanese economy is producing a tripolar world in the sense that there are three major geographical poles of production, the development of three major exclusive trading blocs in the relevant future looks very unlikely. The complementarities and mutual dependence between East Asia and the United States are too great in the near term for either Japan or the United States to want to reduce their trading links significantly; further it is unlikely that most of the other

countries of the Asian Pacific would welcome the creation of a Japan-led East Asian trading bloc. To be sure, the creation of an American free trade area will divert some production that would have taken place in Asia, trade frictions and tough bargaining between trade partners will continue, non-tariff barriers will not disappear, but the fundamental interest of both the Americas and Asia in expanding trade will prevent the disintegration of the trading relationships that have developed since mid-century.

However, Europe may well turn inward<sup>12</sup> and eastward for a time, while the internal market and political and economic union are completed, and relations with new applicants to the EC and Eastern Europe are worked out. This can be done while reducing external trade barriers; we shall have to wait for the conclusion of the Uruguay Round to see which way Europe turns. Short of an extremely improbable all-out trade war, the development of a two-bloc trading world would be moderately costly, but not disastrously so, for the members of the blocs.

But the creation of a two-bloc world would create larger costs for the developing countries that would have to choose sides, and that might be excluded from one or the other large market. The industrialized countries that have benefitted most from the liberal international economic order should not turn their backs on it just as the developing countries are trying to join it, but at least some of them appear ready to do so.

## II. Capital Market Integration

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<sup>12</sup>Through the Lome Convention, Europe provides economic aid and preferential market access to the ACP (Africa, Caribbean and Pacific) developing countries.

At the short end, we live in a global financial market. The internationalization of financial markets is reflected in the possibility of twenty four hour a day trading, and the essentially instantaneous transmission of shocks among major markets, for instance on October 19 1987. Speculators, investors, and finance economists have all gone international. The development of the international markets owes much to financial deregulation in the industrialized economies, and the lifting of capital controls, in Britain at the end of the seventies, in Japan in the early eighties, and during the eighties among other European countries. It owes something but not a great deal to technology. the essential invention in internationalizing financial markets was the telegraph.

Capital markets have also become more integrated at the long end. Investors in the United States, Europe, and Japan directly and indirectly (through pension funds) have larger shares of foreign securities -- often in the form of mutual fund shares -- in their portfolios than they did a decade ago. Nonetheless, individual portfolios are less internationally diversified than they optimally would be.

Foreign direct investment and the internationalization of production are another reflection of the mobility of long term capital.

I take up three issues in discussing the integration of international capital markets: the extent to which interest rates can move differently in inter-linked markets; the extent to which the international capital markets permit the separation of national investment and saving rates; and the aftermath of the international debt crisis.

With perfect capital mobility, nominal interest rates in different countries are linked through the covered interest arbitrage condition:

$$(1) \quad i = i^* + \dot{e}/e$$

where  $i$  and  $i^*$  are the nominal interest rates in the two countries, and the second term represents the rate of depreciation implied by the forward markets for foreign exchange.<sup>13</sup> On the assumption that the forward discount represents the expected rate of depreciation, equation (1) also implies that the expected rate of return in a specified currency has to be the same in all markets.

Covered interest arbitrage seems to prevent a small country from affecting the interest rate. That is indeed the case if the exchange rate is fixed, and expected to remain fixed, and leaving aside risk premia. The slow adjustment of prices nonetheless gives monetary policy some leverage over real output (at a cost to the reserves) in such an economy. Fiscal policy does affect real output in such an economy.<sup>14</sup> When the exchange rate is flexible, the nominal interest rate can be affected through monetary policy.<sup>15</sup> But, as shown by Dornbusch (1976), the exchange rate has to adjust to ensure that covered interest arbitrage holds -- leading, in typical circumstances, to an initial overshooting of the exchange rate beyond its equilibrium level when the economy is hit by a shock.

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<sup>13</sup>I assume away the complications caused by taxes, which are at the center of the paper by Gruen (1991).

<sup>14</sup>The macroeconomics of a small country with perfect capital mobility have been well understood since the fundamental work of Mundell (1967, original in 1963).

<sup>15</sup>Goldsbrough and Teja (1991) discuss the relationship between the exchange rate system and the effectiveness of domestic policies.

Table 4 shows implicit OECD real interest rate forecasts.<sup>16</sup>

Differences among expected short-term real interest rates are extremely large, and even some of the differences among long rates are substantial.<sup>17</sup>

The important point is that real interest rates can differ among countries whose financial markets are linked through covered interest arbitrage.

Consideration of the policy sources of the real interest rate differences -- German fiscal expansion, Japanese monetary contraction, U.S. monetary ease -- confirms that view.

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Table 4: Real Interest Rate Forecasts  
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	Short-term rate (%)			Long-term rate (%)		
	1990-II	1991-II	1992-II	1990-II	1991-II	1992-II
Germany	5.3	4.6	5.7	5.7	4.0	5.1
Japan	6.6	5.5	5.0	6.3	4.6	4.8
U.K.	7.0	6.5	6.6	4.3	4.6	5.6
U.S.	3.5	1.8	2.6	4.9	4.0	4.6

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Source: OECD Economic Outlook, July 1991.

The second point I want to take up is the extent of international capital flows. In an influential article, Feldstein and Horioka (1982) showed that there is a very strong correlation between national saving and investment rates. The implication they draw is that in practice countries have not to any great extent used the international capital markets rather

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<sup>16</sup>The real rate is calculated as the predicted nominal rate for the specified period minus the predicted inflation rate. All data are for the second half of the year.

<sup>17</sup>The comparisons among long rates are less meaningful than those among short rates, since the relevant real long-term interest rate should be the difference between the nominal rate and the rate of inflation over the life of the bond.

than their own saving to finance investment. Their point can be put differently: that current account deficits have not been large relative to the rate of investment. One explanation -- which does not however get down to the fundamental issue -- is that governments have a target of approximate current account balance (Bayoumi, 1990).

The size of the U.S. and Japanese current account imbalances in the 1980s has modified the strength of the relationship found by Feldstein and Horioka. Nonetheless, the international capital markets in the post-World War II world have not moved capital internationally on the same scale as in the pre-1913 world. For a decade before World War I Britain's current account surplus averaged more than 7 percent of its GNP. There were only three years in the 1980s in which Japan's current account surplus exceeded half that share of Japanese GNP; yet the Japanese surplus created major trade frictions.

While current account surpluses and deficits among the industrialized countries may be smaller than they were a century ago, I believe that the conclusion drawn by Feldstein and Horioka is misleading. That is not only because the correlation between savings and investment has weakened in the last decade. It is also because current account deficits should be compared to net rather than gross investment. For instance, between 1984 and 1988 the U.S. current account deficit averaged 3% of GNP; that is only one sixth of gross investment, but over half of net investment. By this measure foreign lending contributed significantly to the growth of the U.S. capital stock -- in addition to its contribution to the ability of the federal government to run large deficits. Thus even

among industrialized countries, international capital flows in the 1980s made possible significant differences between saving and investment rates.

Developing countries have tended to rely relatively more on the international capital markets (including the international financial institutions) for financing. Table 5 shows current account deficits for some developing countries: in 1970, long before the debt crisis; in 1980, just before the debt crisis, when commercial bank lending was flourishing; and in 1988, when the aftermath of the debt crisis was still affecting the heavily indebted countries. The general pattern is for countries (except Korea) to have run moderate current account deficits in 1970, for the deficit to have peaked in 1980 (except for oil-exporting Indonesia), and for countries to have moved to much smaller deficits and in some cases surpluses by 1988.

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 Table 5: Developing Country Current Account Deficits, and Net Transfers\*  
 (% of GNP)  
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	Current a/c deficit			Net Transfers		
	1970	1980	1988	1970	1980	1988
Brazil	2.0	5.5	-1.3	2.8	-0.0	-2.5
Chile	1.1	7.4	0.8	2.2	4.9	0.4
Indonesia	3.2	-4.0	1.8	5.3	-3.4	-2.3
Korea	7.0	8.8	-8.4	4.2	1.2	-2.6
Mexico	2.9	5.7	1.5	0.1	1.6	-4.5
Philippines	0.7	5.4	1.0	1.1	1.4	-1.4
Thailand	3.5	6.5	2.3	1.2	4.9	-0.1

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 \* Negative current account deficit corresponds to a surplus.

Source: World Bank, World Debt Tables, 1990-91, Volume 2.

Most of the economics of foreign borrowing can be understood using one simple relationship:

$$(2) \quad \dot{d} = x + (r-g)d$$

where  $d$  is the ratio of external debt to GNP,  $x$  is the non-interest current account deficit,  $r$  is the interest rate on the external debt, and  $g$  is the growth rate of GNP. The debt equation in words is:

$$(2)' \quad \begin{array}{l} \text{rate of change of the debt/GNP ratio} = \\ \text{non-interest current account deficit} + \\ (\text{interest rate} - \text{growth rate}) \times (\text{debt/GNP ratio}) \end{array}$$

For any given non-interest current account deficit, the key to the dynamics of debt is the relationship between the interest rate on the debt and the growth rate of GNP,  $(r-g)$ . So long as the growth rate of GNP exceeds the interest rate, foreign borrowing is relatively benign. When the interest rate exceeds the growth rate of GNP, the ratio of debt to GNP tends to rise over time unless the non-interest current account moves into surplus.

The non-interest current account deficit is equal to the real transfers of goods and services that a country is receiving from abroad -- the amount of extra resources over and above domestic production that is available for consumption or investment. So long as the growth rate exceeds the interest rate, a country can receive transfers from abroad without facing a rising debt-GNP ratio: growth takes care of the interest on past loans. However, the logic of debt -- that it has to be paid off -- comes into force when the interest rate exceeds the growth rate.

All the countries in Table 5 received positive net transfers in 1970, and most of them (except Indonesia, and -- marginally -- Brazil) were receiving net transfers in 1980. But by 1988 net transfers were negative for all the countries in the table, except Chile. Most of the Asian countries listed grew rapidly in the 1980s, and moved with little disruption from receiving to making net transfers abroad. The shift was anything but smooth for the three Latin American countries and the Philippines, whose forced adjustment is part of the international debt and development crisis of the 1980s.

What lessons should we draw from the international debt crisis? Should countries seek to avoid using the international capital markets to finance development in future, striving to be neither a borrower or lender? Many countries do not have the choice at present, but those who avoided crisis or adjusted rapidly to it in the 1980s, do. The answer, from the nineteenth century as well as more recent experience, is clearly that countries and the firms in them can make use of the international capital markets to increase their growth. The Korean borrowing pattern is one example, and so are the examples of some other Asian countries, or in earlier times, of the United States and Canada.

But the debt crisis and the debt dynamics equation suggest other lessons. First, borrowing has to be undertaken to finance productive investments, which are likely to generate the resources needed to service the debt. This rule is so ancient and so self-evident that it would not need stating if both the banks and borrowing countries had not violated it in the late seventies and early eighties.

Second, because it is impossible to know ex ante how productive investments will be, there are many advantages to foreign capital inflows that share the risk of the investments they finance. This is one of the advantages of both foreign direct investment and portfolio investment. In terms of the debt dynamics equation, risk-sharing forms of foreign capital inflows can be seen, loosely, as relating the interest rate to the growth rate. More innovative forms of financing, for instance commodity bonds, can also help share the risk between the borrower and the lender.

Third, the real interest rate can change rapidly. The sharp increase in the real rate in the early eighties, which has more or less been sustained until now, was one of the causes of the debt crisis. Or, to take a more current example, within the last year, the real interest rate in Japan moved from 2% to 6%. More significantly, the current level of the real interest rate is high by historical standards, imposing a much tougher hurdle for successful borrowing than for most of the post-War period, or in the nineteenth century. Because borrowing is today very expensive by historical standards, the level of resource transfers that can be financed through international capital flows is lower than it used to be.

A fourth lesson of the debt crisis is that domestic firms should not be given unrestricted access to foreign borrowing, particularly non-equity financing. In both Chile and Argentina, the lenders in essence forced the government to take over the debt of failing private borrowers. The argument was that the credit of the country would be impaired unless the government stood behind its domestic firms. In some cases, governments have stood firm and forced foreign lenders to bear the costs of their

lending mistakes. But in general failed loans impose externalities on other firms and the government of a country. For this reason, governments should monitor even private sector borrowing, and may sometimes have to limit such borrowing.

Of course, government rather than private overborrowing was the more common cause of countries' debt crises. It probably does not help to offer the advice that countries should not overborrow,<sup>18</sup> but it may help to point to some of the consequences. Largely as a result of the debt crisis, per capita output barely grew in Latin America in the 1980s.<sup>19</sup>

Normal access to the international capital markets is some way off for many of the heavily indebted countries. These countries have to rely entirely on their own saving and the international financial institutions to finance their growth -- and the surest way known to increase national saving is by increasing public sector saving. Even countries that now have access to the international capital markets have to rely primarily on their own saving to finance their investment. But the international capital markets, handled with due caution, offer important opportunities to finance investment to those countries that do have access, or such as Chile and Mexico, that are making their way back to the markets.

### III. Taking Advantage of Global Integration

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<sup>18</sup>Of course, countries cannot overborrow without lenders overlending. The commercial banks are well aware of the consequences of overlending to developing countries in the late seventies and early eighties.

<sup>19</sup>The argument is sometimes made by countries that have continued to service their debt in the eighties that they would have been better off defaulting and getting debt relief -- from the Paris Club, or the Brady Plan, or simply through arrears. A close look at the travails of the heavily indebted countries that have had trouble servicing their debt suggests otherwise.

What do these general arguments about the integration of the international economy mean for particular developing countries,<sup>20</sup> with respect to trade, integration into world financial markets, and domestic financial policies respectively?

Trade.

The case for participating vigorously in world trade is increasingly accepted. The successful experience of outward-oriented economies is one of the key lessons of development experience embodied in the modern development consensus, expressed for instance in the 1991 World Development Report and in the growing openness of developing economies all over the world. What precisely the lessons of East Asian experience are is still debated, between those who see the experiences of Korea and Japan as proving the virtues of state guidance of industrial development, versus those who argue that Hong Kong establishes the opposite and that Korea went badly wrong when the government encouraged the move into heavy and chemicals industries.<sup>21</sup>

There is little doubt that Korea and Japan provided substantial and directed assistance, including credit subsidies and import protection, for export industries. But they provided at most only temporary protection, after a finite period aligning their price structures with those of the international economy, and they encouraged vigorous domestic competition.

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<sup>20</sup>This question is the focus of Watanabe's (1991) paper.

<sup>21</sup>For the view that the Korean experience establishes the success of government intervention, see Amsden (1990); for the view that the market-friendly orientation of those interventions was the key to their success, see the World Development Report 1991, Chapter 5.

With regard to the guiding role of the bureaucracy, I believe that has to depend on the quality of the government in each country, and that an active policy of trying to pick the winners is likely to be costly for most developing countries. Research continues on the characteristics of policies and governments that can make for successful government intervention.

The general formula for liberalizing trade is to start by replacing quantitative restrictions by tariffs, and then to reduce tariffs, preferably through uniform shrinkage, and on a preannounced basis. The speed of reduction should depend on domestic conditions, and should take into account the budgetary consequences of cutting tariffs -- a real consideration in countries that have weak tax systems.

Developing countries can also contribute to maintenance of an open international trading system, by taking an active pro-trade, and pro-multilateral trade, role in the many international negotiations and disputes over trade. The creation of the Cairns Group, and the aggressive free trade stance of Mexico, are examples of the potential role of developing countries in supporting the free trade position. The mercantilist impulse is very natural and very strong; it is impressive that it has been pushed back for most of the last half-century, but a source of real concern that protectionist pressures have become much stronger in the United States and other industrialized countries. United States leadership was decisive in moving the world towards free trade after World War II; as that leadership weakens, free trade needs all the friends it can get.

The benefits of trade in goods extend also to trade in services. The almost reflex reaction that domestic financial institutions should be protected from foreign competition should be rejected in favor of a more serious analysis of the benefits that foreign competition in the provision of these services can bring. Foreign competition is unlikely to reach far into the domestic retail banking sector, but can bring the benefits of both competition and new knowledge in merchant and investment banking. Similarly, competition for the domestic insurance industry can be helpful. Whatever prudential and other regulations apply to domestic firms should be applied to foreign owned firms as well.

Integration into World Financial Markets.

The liberalization of international capital flows poses potentially more difficult problems for developing countries. Consider first a fully open capital account that permits both short and long-term capital mobility. The experience in the Southern Cone at the end of the 1970s, when countries trying to stabilize through tight money drew in large capital flows that led to appreciation and overvaluation of the currency is a basic reference point for the discussion.<sup>22</sup> These episodes took place towards the end of the period of massive capital flows that culminated in the debt crisis; the overvaluations to which they contributed helped worsen the crisis when it came. One lesson that has been drawn from those cases is that capital flows should not be liberalized until domestic stabilization has been achieved. This advice reflects the large fiscal deficits that were being run by the Southern Cone economies.

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<sup>22</sup>See Dornbusch (1988), Edwards (1984), and Obstfeld (1986).

Governments that have control over their deficits, such as Indonesia, or at present, Mexico, can tighten fiscal policy to reduce domestic interest rates and thus discourage capital inflows. Alternatively, governments can tax capital inflows (foreign borrowing), as the Israeli government did in the late seventies, thereby making foreign borrowing more costly for domestic residents. These taxes are, though, difficult to enforce.

Despite the general argument that liberalization of international capital flows should generally come late in the adjustment process, some countries, such as Indonesia, liberalized foreign exchange transactions early and successfully. Others, such as Mexico, are not able to control capital flows, and have nonetheless adjusted successfully. There is a credibility argument for early liberalization: governments that permit the free flow of capital internationally signal their confidence that their economy will be well-managed, and subject themselves to the discipline of the market's views of the likely course of the current account or the exchange rate. Nevertheless, a government that is not yet fully in charge brings unnecessary complications to its management of the economy by opening the capital account early.

Countries can derive benefits from inflows of longer-term capital even before full liberalization of foreign exchange markets. All capital inflows enable the country to supplement the financing of investment. The potential disadvantages of floating interest rate general purpose borrowing, or debt finance for firms, have already been discussed.

Portfolio investment and especially foreign direct investment should be viewed in a different light, however. In the first instance, the servicing of these debts will be related to the success of the investments they finance, which will usually be highly correlated with the growth of the economy. The risk characteristics of such borrowing are therefore preferable to those of debt finance -- though on average, to compensate for the more favorable risk characteristics, the cost of such finance will be higher than that of debt finance.

Foreign direct investment (FDI) brings with it the added benefits of potential access to foreign management skills, technology, and markets.<sup>23</sup> Hostility to FDI has been replaced by international competition for its benefits. The general principle that foreign investors should not be given more favorable conditions than domestic investors is not always observed, and some foreign investment is undoubtedly attracted by tax holidays, subsidies, and access to protected markets.

Foreign direct investment expanded rapidly worldwide in the 1980s, particularly among the industrialized countries. Although the share of FDI going to developing countries fell from 23% in 1980 to 14% in 1988, the total flow to developing countries -- some of it from other developing countries -- more than doubled (Table 6). Continued expansion of FDI

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<sup>23</sup>Protectionist pressures have increased FDI in industrialized countries; foreign firms invest abroad to get in under quotas and other trade restrictions. Although there are no precise data, recent FDI in developing countries seems increasingly oriented to manufacture for export, rather than to gain access to the domestic market. (See the World Bank's World Debt Tables, 1990-91, pp 46-47 for an analysis of recent trends in FDI).

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**Table 6: Foreign Direct Investment in Developing Countries**  
 (\$ billion)  
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	1970	1980	1985	1988
Total to LDCs(net)	1.6	9.1	10.6	19.1
LDC/Total (%)	20.0	23.0	24.0	14.0
FDI/Net resource flows to LDCs (%)	15.8	11.0	18.6	31.4
To LDCs from Japan	0.2	1.4	1.0	3.8
China	0	0	1.7	3.2
Korea	0.1	0.0	0.2	0.9
Thailand	0.0	0.2	0.2	1.1

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 Source: World Bank, World Debt Tables, 1990-91, Volumes 1 and 2.

will need supportive domestic policies in the potential recipient countries. Since the policies supportive of foreign investment are generally the same as those supportive of domestic investment, this means that countries that manage their economies well, are likely to be able to attract increasing amounts of foreign capital in the form of direct investment.

There are also increasing opportunities for developing countries to hold reserves and borrow (both government and private sector) in innovative commodity-price related hedging instruments. The issue is less short-term hedging, for which purpose countries can and do participate in the international commodity and futures markets, but longer-term instruments.

The basic elements of supply and demand are clear: the exporters want long-term stability of export revenues, which now fluctuate because

commodity prices do; the importers want long-term stability of input prices, which fluctuate for the same reason. Here the development of oil- and copper-price related instruments represent the beginnings of a set of markets with enormous potential. These markets could eventually serve as a market-based alternative to commodity price stabilization schemes.

Domestic Financial Policies.

The financial sector has long been the source of the most spectacular examples of fraud and mismanagement in both industrialized and developing countries.<sup>24</sup> Because of the crucial roles of deferred payments and therefore of information, and of economies of scale, this is not an industry where laissez faire works well. The need for a careful system of prudential regulation in financial intermediaries is widely recognized, as is the fact that prudential management has failed even in the United States.<sup>25</sup>

The requirements for a system of prudential regulation are set out in the World Development Report 1989. The focus of the regulations has to be the banking system, with the goal of producing a robust system, even at the cost of some sophistication. To the extent that other intermediaries that hold more speculative assets develop, it should be established loudly and repeatedly that investors in those institutions are not protected by public insurance. Foreign institutions with their broader capital bases can play an important role in providing financing for expanding domestic firms.

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<sup>24</sup>Manchester and McKibbin (1991) estimate the costs of the Savings and Loan debacle in the United States to be \$300 billion in the 1980s and over \$350 billion in the 1990s.

<sup>25</sup>The issue here is not the causes of U.S. financial institution failures, but the fact that they occurred.

Although stock markets provide much excitement, they are not typically an important source of finance in the early stages of development. Even in industrialized economies, the bulk of firm financing comes from retained earnings and from borrowing from banks or other financial institutions. Thus the development of a stock market need not be a high priority; but there is no reason to oppose the development of the market, provided that the appropriate prudential regulations are put in place.

#### IV. Concluding Comments

The trends to an open global economic order appear unstoppable. Eastern Europe and the Soviet Union, Latin America and Africa, and now India too, are all moving in the same direction. These remarkable changes make optimism too easy. Progress is not inevitable and the new world order does not have to be a coherent and open one. The Uruguay Round may finally break down, the international economy instead of becoming unified may split into trading blocs, and the volume of international trade may begin to fall.

Both Africa and Latin America have to revive growth after a lost decade. If the open-economy market-oriented strategies that are now so confidently advanced and adopted do not succeed, countries will turn elsewhere. They will study the East Asian examples carefully. They will ask why China, which is reforming in some directions but not others, is doing so well.

Fortunately some countries, in particular Mexico and Chile, are seeing the fruits of greater participation in the international economy. But we should not exaggerate the impact of these policies on growth. Chile and Mexico each took several years to turn around, and neither is growing at East Asian rates. None of the African countries has turned around in the same way.

We should not be over-optimistic, and we should certainly not over-promise. But with all due caution, recognizing the progress that has been made by countries that have participated fully in the international economy, and the collapse of centrally planned economies, we should be optimistic both about the potential gains from global integration of trade and finance, and the likelihood that many will realize them.