GLOBAL RULES AND MARKETS: CONSTRAINTS OVER POLICY AUTONOMY IN DEVELOPING COUNTRIES

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A. Introduction

Recent years have seen a rapid opening up and integration of developing countries into the world economy to a degree unprecedented in modern history. This has no doubt brought benefits in several areas, particularly through international trade and investment, even though their incidence varied among and within countries. But it is also true that rapid liberalization and integration have also caused dislocations in the developing world, particularly among the poor and unprivileged. While these challenges have placed growing demand on policy makers and called for greater flexibility in the policy-making process, many of the traditional instruments of development and macroeconomic policy have become ineffective or simply unavailable because of proliferation of international rules, obligations and practices. Consequently questions have been raised about whether such constraints over national economic policy are compatible with development, including the capacity to foster conditions for steady quality employment growth.

This paper deals with this issue. The following section sets the scene. After a brief discussion of the concept of policy autonomy it focuses on the sources of the constraints, the rationale for multilateral rules as a global collective action, the nature of existing multilateral disciplines and their relative impact on policy space in developed and developing countries. This is followed by a discussion of the constraints exerted by multilateral rules and practices on development policy in four key areas; industrial tariffs, industrial subsidies, and investment and

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technology policies. Section C concentrates on macroeconomic policies and examines the extent to which they are circumscribed by influences associated with external financing, both private and official. It takes up the implications of capital account liberalization and the conditionalities imposed by the lending practices of multilateral financial agencies and bilateral donors for monetary and fiscal policies. Throughout the discussions attention is paid to the economic significance of constraints, the space that is available and used, and the reforms needed to make multilateral rules and practices compatible with the development trajectories of poor countries. The paper will conclude with a summary of the main arguments and recommendations.

B. Global economic integration and policy space

The autonomy of national economic policy refers to the effectiveness of national policy instruments in achieving national policy objectives.[1] However, even in a closed economy largely insulated from foreign influences, there are limits to what economic policy can do. Policy makers do not always have full control over instruments such as taxes, interest rates or public spending because of technical and political limits and contractual obligations. More importantly, formal command over policy instruments does not always translate into full control over objectives because there are not always enough instruments to assign to all targets independently, or for reasons such as instability of and uncertainties in the relationship between instruments and targets, and trade offs among various potential objectives such as stability and growth or equity and efficiency. Liberalization of domestic markets and deregulation of economic activities narrow the policy space further by reducing the number of instruments controlled by policy makers.

In a world of economic interdependence where borders are largely open to flows of goods and services, money, capital and labour, policy autonomy is restricted further for two reasons. On the one hand, openness enhances the influence of foreign policies and conditions in markets

[1] The distinction between instruments and targets constitutes the basis of theory of economic policy first elucidated by Tinbergen (1952 and 1956); see also Hansen (1967) and Bryant (1980: chap. 2).

abroad on economic performance while weakening the impact of national policy instruments. On the other hand, it diminishes control over policy instruments – that is, *de jure* sovereignty of national economic policy – because closer global integration is often accompanied by insertion into international governance systems and growing international obligations.

A key factor limiting policy space is multilaterally negotiated rules and obligations in trade and finance, as embodied in various agreements in the World Trade Organization (WTO) and, to a lesser extent, the Articles of Agreement of the Bretton Woods Institutions (BWIs). However, these are not the only and, for some countries, even the most important constraints over policy autonomy. For those dependent on official financing, the policy space left by multilateral legislation is constantly eroded by conditions attached to loans and grants by multilateral financial institutions and bilateral donors. Again, commitments undertaken by several developing countries in bilateral or regional agreements with major industrial countries do not only extend WTO disciplines in industrial tariffs, services and intellectual property rights, but also include new obligations in areas left outside multilateral legislation such as capital account regimes, foreign direct investment (FDI) and enforceable environment or labour standards. In addition, several developing countries have seen their macroeconomic and industrial policy options significantly narrowed by unilateral and voluntary liberalization, particularly with respect to capital account, trade and FDI regimes.

Unilateral liberalization, voluntary or otherwise, is a policy decision which can, in principle, be reversed. However, policy reversals are costly. They alter the incentive structure and give rise to "adjustment costs"– that is, in the process of adjustment to new incentives resources may remain unemployed, skills may be eroded, equipment may become obsolete, fiscal, trade and financial imbalances may emerge, or there may be all kinds of costs in learning to live with the new set of policy rules. For instance rapid trade liberalization is recognized to give rise to adjustment costs even though they are rarely incorporated in the estimates of benefits of liberalization (Akyüz 2005c). Similarly, reintroduction of barriers after a long-period of openness would entail adjustment costs. They tend to be much higher for large shifts in structural policies than macroeconomic policies, except perhaps when introduced as temporary

measures. Moreover, reversal of liberalization can trigger adverse financial market reaction and give rise to capital flight and sharp declines in currency and asset markets, with repercussions for economic activity.

Similarly, theoretically there is always the option for a country to exit from multilateral arrangements and conduct its international business on a bilateral basis. This too would also give rise costs and adverse reactions. More importantly, such an option is rarely exercised by developing countries because of their inherent weaknesses in bilateral relations with major economic and political powers. Thus the agreement reached during the eleventh session of the United Nations Conference on Trade and Development that "it is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space" (UNCTAD 2004a: para 8) has little practical significance for most developing countries. This is also why multilateralism is so valuable to smaller and weaker countries, particularly if, as noted in the same declaration, an appropriate balance is struck "between national policy space and international disciplines and commitments."

In a world where national economies are closely connected, there is strong rationale for multilateral disciplines as a global collective action. Multilateral rules and obligations are needed to contain negative externalities such as financial contagion and environmental degradation. They are also needed to prevent discriminatory and beggar-my-neighbour policies, such as attempts to export unemployment through mercantilist trade and exchange rate policies. However, it should also be recognized that proliferation of multilateral constraints poses the risk of repudiation of obligations, and can lead to loss of credibility for multilateral institutions. Therefore, effective and credible multilateral disciplines call for a balance between national policy autonomy and multilateral rules and obligations. They also call for coherence among arrangements in interrelated aspects of international economic interactions such as trade and finance so that difficulties in one field do not undermine relations in others.

Drawing on the interwar experience, the postwar planners sought to strike a balance between national policy autonomy and multilateral disciplines, and coherence between trade and

finance. Diversity in national strategies for openness and the balance between private and public action was recognized, and the main objective pursued in trade was to prevent the recurrence of discriminatory policies of the kind widely practiced during interwar years. Accordingly, the unconditional most-favoured nation (MFN) principle was placed at the centre of the General Agreement on Tariffs and Trade (GATT). On the other hand, recognizing that currency stability was essential for the expansion of free trade, and that "tariffs and currency depreciations were in many cases alternatives" (Keynes 1980: 5) the arrangements limited the scope of financial markets to generate erratic movements in exchange rates by imposing restrictions over short-term capital flows. The ability of governments to manipulate exchange rates of their currencies was also restricted through obligations to maintain them within the narrow range of multilaterally agreed par values, but they were also allowed to change their par values under fundamental disequilibrium.

Current arrangements represent a fundamental shift from this approach. They are dominated by an agenda set by leading economies to achieve deep global economic integration through rapid liberalization in a wide range of areas that accommodate their own development prerequisites, compared to shallow integration sought by postwar planners in recognition of diverse national strategies (Ostry 2000). Liberalization is pursued where advanced countries have the upper hand including trade in industrial products, movement of money, capital and enterprises, but restrictions continue unabated over trade in agricultural products, labour mobility and technology transfer where liberalization would generally benefit the developing world.

Multilateral disciplines in trade now serve to restrict not so much discriminatory treatment among countries but government intervention vis-à-vis markets. The MFN principle has increasingly been replaced by "market access" and "national treatment" as liberalization and non-distortion have become the organizing principles of international trade and investment. The drive for greater liberalization than is found feasible at the multilateral level has given rise to proliferation of discriminatory bilateral and regional free trade agreements, thereby constantly eroding the MFN principle.

In money and finance, both pillars of the postwar international monetary arrangements – restrictions over short-term capital flows and exchange rate obligations – disappeared with the demise of the Bretton Woods arrangements. In effect, finance has become the vanguard of the international liberal order, premised on the assumption that financial markets can do their own disciplining and do not need international rules or policy intervention.

These also mean that the existing multilateral system lacks coherence between trade and finance. Unlike trade and the so-called trade-related areas that are constantly pushed onto the agenda of the WTO by advanced countries, there are no multilateral disciplines over exchange rate and macroeconomic policies even though it is generally recognized that exchange rate stability and discipline is a prerequisite for open and expanding trade.[2] Attempts to balance lack of specific exchange rate obligations with greater emphasis on policy surveillance by the IMF have failed to secure international monetary and financial stability. The Fund is unable to exert meaningful disciplines over the policies of its non-borrowing members, including all industrial and some developing countries, and prevent unsustainable exchange rates, persistent payments imbalances and currency manipulations.[3] For its borrowers, by contrast, the policy advice given by the IMF in Article IV consultations often provide the framework for conditions to be attached to any future Fund program and lending (IMF/GIE 1999: 20). Thus, even though, as stipulated in Article IV, all countries have the same *de jure* obligation "to assure orderly exchange rate arrangements and to promote a stable system of exchange rates", the Fund's policy oversight is confined primarily to its poorest members who need to draw on its resources because of their lack of access to private finance and, occasionally, to emerging-markets experiencing interruptions in their access to private financial markets.

[2] The importance of coherence among different components of international economic system was put in broader terms in paragraph 4 of the Marrakech Declaration: "Ministers recognize, however, that difficulties the origins of which lie outside the trade field cannot be redressed through measures taken in the trade field alone. This underscores the importance of efforts to improve other elements of global economic policymaking to complement the effective implementation of the results achieved in the Uruguay Round"– WTO (1994: para 4).

[3] Ironically, the United States government is now unable to invoke multilateral rules and obligations either in the IMF or in the WTO against China for what it considers as exchange rate manipulation– Denters (2003).

Thus, while industrial countries escape multilateral disciplines in money and finance, developing-country borrowers from the BWIs face conditionalities that circumscribe not only their macroeconomic policies but also broader development strategies. But this is not just a matter of imbalance between developed and developing countries in the policy constraints they encounter in the BWIs. The absence of multilateral disciplines over exchange rate and macroeconomic policies in leading countries with disproportionately large impact on global monetary and financial conditions is also major concern to developing countries because of their vulnerability to external financial shocks.

Even where the rules and practices apply equally to all countries, as in much of the WTO agreements, they impinge differently on policy space in different countries because of variations in levels of development. As a result of WTO rules and obligations, many policy instruments widely used by both mature and late-industrializers to reach their current levels of development are no longer available to developing countries. In legal terms international rules and obligations provide a level playing field for all parties, but effective constraints they impose over policies tend to be much tighter for developing than for industrial countries. The degree to which they narrow policy space also varies considerably within the developing world for the same reason.

C. Multilateral disciplines and development policy

Binding and enforceable rules and obligations contained in several agreements in the WTO constitute the principal constraints on development policy.[4] Even though the so-called escape clause or safeguards allow a member to suspend its obligations, such provisions can be invoked only on a temporary basis. Exceptions granted to developing countries – the so-called special and differential treatment, SDT– allow them, under certain conditions, to enjoy preferential market access or to offer limited or less-than-full reciprocity. However, the SDT is generally confined to longer transition periods or left to "best endeavour" which allows

[4] In addition to the GATT these include the General Agreement on Trade in Services (GATS), Trade Related Aspects of Intellectual Property Rights (TRIPS), Trade Related Investment Measures (TRIMs), and Subsidies and Countervailing Measures (SCM).

considerable discretion to industrial countries in its interpretation and implementation. Specific provisions allowing developing countries to deviate from their obligations in order to safeguard their external financial positions or to support infant industries either bring temporary relief or require compensatory concessions to countries adversely affected. [5]

Structural conditionalities attached to lending by the BWIs constitute the second most important source of multilateral constraints over development policy. These cover a wide area, including trade and finance, public enterprises, labour market institutions and social safety nets (Goldstein 2000; Kapur and Webb 2000; and Buira 2003). The average number of structural conditions in IMF programs doubled between the 1970s and 1980s, and at the end of the 1990s it was more than fifty for a typical Extended Fund Facility program and between 9 and 15 for standby programs. On a narrow definition, the number of conditions attached to lending at the end of the 1990s by the Fund and the Bank together ranged between 15 and 30 for sub-Saharan Africa and 9 and 43 for other regions (Kapur and Webb, 2000: 5-7). These numbers go up considerably if a wider definition is adopted.

The following sections will examine the extent to which these rules, obligations and practices impinge upon policy space in developing countries in four key areas.[6] Discussions will focus on WTO-related constraints, but reference will also be made to structural conditionalities by the BWIs. Macroeconomic conditionality and the impact of trade liberalization on fiscal space will be taken up in the discussion of monetary and fiscal polices.

1. Industrial tariffs

During the Uruguay Round negotiations developing countries assumed extensive obligations with respect to industrial tariffs by binding them at significantly reduced levels compared to previously applied rates. While some countries, notably in Latin America, opted for

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[5] For a lucid analysis of the framework for international trade, its principles, rules and exceptions see Das (1999).

[6] For more detailed treatment of restrictions in these areas see Akyüz (2007).

full binding coverage, others left part of the tariff lines unbound. The average binding coverage in developing countries is now 77.5 per cent (Fernandez de Cordoba and Vanzetti 2005: 7). In some 30 countries binding coverage is less than 35 per cent, and about two-third of these are least-developed countries (LDCs). Average bound industrial tariffs in the developing world now stand at less than 30 per cent while the average applied tariffs are much lower, a little over 10 per cent. There is, however, considerable diversity in both respects: average bound tariffs vary between 5 and 70 per cent while applied tariffs between 2 and 31 per cent.

Compared to the historical experience of mature industrializers, industrial tariffs in developing countries today are exceptionally low. For instance, at the end of the 19th century when per capita income (measured in purchasing power parity) in the United States was at a similar level as that in developing countries today, its average applied tariffs on manufactured imports was close to 50 per cent. Even after the war when the United States and Western Europe had reached industrial maturity and per capita income levels several times those in the developing world today, their average industrial tariffs were considerably higher – even compared to those in the so-called high tariff countries such as India (Akyüz 2005c: table 1).

Protectionism was the rule, free trade the exception during the industrialization of today's mature economies (Bairoch 1993). While leading industrial countries often favoured free trade, followers supported and protected their infant industries in order to catch up. Although historically trade liberalization came only after industrial competitiveness was achieved, developing countries are now advised to liberalize in order to establish industrial competitiveness. Consequently, the outcome in countries which resorted to rapid liberalization before making reasonable progress in industrial development and competitiveness has been quite dismal. Imports often responded much more vigorously than exports, causing balance of payments problems and losses of industrial output and employment. According to some estimates total income losses for sub-Saharan Africa from premature trade liberalization

amounted to $270 billion over the past two decades – more than the total aid received by the region.[7]

Large differences between applied and bound tariffs in developing countries show that an important part of trade liberalization has occurred outside the WTO. Conditionality by the BWIs has certainly played an important role. During the Doha Round, the IMF argued that "countries that press ahead with unilateral liberalization will enjoy enormous benefits" (Krueger 2005: 5). It also introduced a Trade Integration Mechanism to mitigate concerns among some countries that their balance-of-payments could suffer as a result of liberalization in the WTO, insisting that such shortfalls would be small and temporary (IMF 2005b). No doubt these compromise the bargaining power of developing countries in multilateral negotiations since a country liberalizing unilaterally acquires no automatic rights in the WTO vis-à-vis other countries. Furthermore, WTO negotiations often make reference to applied tariffs as benchmarks for binding and cuts.[8]

In so far as WTO obligations are concerned there is still room to use tariffs particularly where they are left unbound or bound at levels considerably higher than the applied rates. But such space is rarely used even at times of serious balance of payments difficulties, partly because of problems associated with policy reversals noted above, and partly because of the commitment of ruling elites to liberal trade regimes. However, it is also notable that many developing countries have been resisting to giving up such space during the Doha Round despite a strong mercantilist offensive by developed countries, which have been seeking to bind all industrial tariffs of developing countries at drastically reduced levels on a line-by-line basis, in effect translating unilateral liberalization into multilateral obligations (Khor and Chien Yen, 2004).

Several sectoral studies, including those in the mainstream tradition, suggest that the proposals made by industrial countries during the Doha Round could lock developing countries

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[7] Kraev (2005). See also UNCTAD TDR (1999); Santos-Paulino and Thirlwall (2004); UNCTAD (2004b).

[8] For instance, Annex B of the so-called July package which provides the framework for Doha negotiations takes applied rates as the basis for commencing cuts in unbound tariffs (WTO 2004).

into the existing international division of labour.[9] With a rapid move towards free trade, developing countries would exit from, or fail to enter, technology-intensive, high value-added sectors, leaving these to more advanced countries and concentrating, instead, on low-value-added, resource-based and labour-intensive products. This would be a major setback because the pace of their industrial development would depend on how fast they can move away from such an international division of labour. An irreversible commitment to low tariffs on all manufactures could make re-entry into such sectors very difficult, particularly since many other instruments of policy widely used in the past by industrial countries are no longer available because of WTO agreements on subsidies, TRIPS and TRIMs.

It is not that developing countries need high tariffs for all sectors indefinitely. But they should have the option of using tariffs on a selective basis as and when needed for industrial upgrading while remaining subject to multilateral disciplines. This could be done by setting a reasonable limit on average tariffs while leaving the rates for individual products unbound. This would encourage governments to view tariffs as temporary instruments since they would need to lower tariffs on some products in order to raise them elsewhere. Such flexibility is provided for in the case of agricultural subsidies, extensively exploited by developed countries, where countries are left free to allocate an agreed total as they wish.

2. Industrial subsidies

Developing countries enjoyed considerable freedom regarding the use of industrial subsidies under the GATT regime, but this is no longer the case after the agreement on SCM, which brings much tighter constraints than is the case for industrial tariffs. The agreement prohibits the so-called trade-distorting, sector-specific subsidies for export promotion and import substitution. Prohibitions apply not only to budgetary transfers in various forms but also intra-private sector transfers affected through government regulation, such as indirect subsidies

[9] Issues taken up in the next two paragraphs are discussed in greater detail in Akyüz (2005c).

provided to preferential credits in the banking sector by non-preferential borrowers. Specific subsidies for research and development (R&D), disadvantaged regions and environmental purposes are exempted. LDCs and countries with a per capita income of less than $1.000 (Annex VII countries) are permitted to use export subsidies until graduation from this category.

In reaching their current level of industrialization, both mature and late industrializers made extensive use of industrial subsidies now outlawed by the agreement on SCM. These include direct payments, tax credits and tax holidays for import-competing and export sectors; generous tax rebates and duty drawbacks for exporters; selective allocation of licences for technology imports and investment; preferential access to credit at subsidized interest rates for export financing and investment; and subsidized infrastructure services.[10] Furthermore, the WTO rules allow both export subsidies and domestic support to agriculture whose main beneficiaries are the industrial countries.

It is mainly the middle-income developing countries that bear the brunt of restrictions stipulated by the agreement on SCM. The exceptions granted to Article VII countries provide them more space than they can possibly exploit given their financial constraints. The rules also impose few constraints on those countries seeking to subsidise development of a fledgling industry that may not yet be export-oriented or subject to significant import competition (Weiss 2006: 6). This can be important for small firms which usually begin by supplying local markets. As for industrial countries, they are the main beneficiaries of the general exceptions allowed for R&D, environment and regional development. R&D subsidies meet the needs of most of these countries to support innovation and technological progress. Furthermore, evidence suggests that the ambiguities surrounding the distinction between economywide and sector-specific subsidies (Anderson 2002: 168) are exploited mainly by industrial countries which support import-competing and export industries through carefully crafted and disguised subsidies without contravening WTO rules and triggering retaliatory action (Weiss 2006).

[10] For measures used in late industrializers in Asia see Weiss (2005) and English and de Wulf (2002).

The market failure argument is often invoked to justify the exceptions made for R&D, environmental and regional subsidies. But the literature is also replete with examples of capital market failures and externalities which necessitate infant-industry support to enable firms to undertake investment with high social return which they would not otherwise be willing or able to make. A possible reform to create greater space for countries at intermediate stages of industrialization could be to allow them to use industrial subsidies subject to an aggregate limit, and leave them free in their allocation among different firms and industries. This would be similar to the provisions on Aggregate Measure of Support (AMS) for agriculture where targets for percentage reduction were set at the aggregate level while leaving considerable flexibility to countries in the allocation of reductions among different products (Das 1999: 242; UNDP 2003: 118-119). These limits could also be supplemented by the kind of provisions currently applied to Annex VII countries in the use of export subsidies; that is, to allow them until the industry becomes competitive, as determined by some measure of its share in the world trade in that product. Like the proposal for industrial tariffs above, such an arrangement would reconcile flexibility with multilateral disciplines in the use of industrial tariffs by developing countries.

3. Investment-related policies

In addition to prohibition of specific investment subsidies linked to export performance or import competition, there are two main sources of WTO disciplines on investment-related policies; the agreement on TRIMs and specific commitments made in the GATS negotiations for commercial presence of foreign enterprises. The TRIMs agreement applies to all investment, but restrictions on measures that could be employed are particularly important for FDI. These include prohibition of domestic content requirements whereby an investor is compelled or provided an incentive to use domestically produced rather than imported products, and foreign trade or foreign exchange balancing requirements linking imports by an investor to its export earnings or to foreign exchange inflows attributable to investment. By contrast, there are no WTO disciplines restricting beggar-my-neighbour FDI policies by recipient countries through various incentives which often provide effective subsidy to foreign investors and influence investment and trade flows as much as domestic content requirements or export subsidies,

particularly since a growing proportion of world trade is taking place among firms linked through international production networks controlled by TNCs. Nor are there effective multilateral codes of conduct for TNCs which are known to practice trade-restricting policies.[11]

Both theory and evidence show that benefits of FDI in terms of transfer of technology and managerial and organizational skills are not spontaneous but greatly shaped by policy. This is why both mature and late industrializers made extensive use of performance requirements for FDI (Chang 2003; Kumar 2005; and Rasiah 2005). The significance of such requirements has grown in recent years because of rapid spread of international production networks controlled by TNCs from industrially advanced countries. For developing countries extensively participating in such networks, notably in automotive and electronics industries, raising domestic content in assembly industries is important not so much because balance-of-payments reasons as because development of domestic industries for technology-intensive parts and components constitutes an important step in industrial upgrading.

The agreement nevertheless leaves some scope for pursuing effective FDI policies. It is possible to design entry conditions of foreign enterprises so as to circumvent restrictions over domestic content requirements – e.g., allowing entry to assembly industries conditional to investment for producing high-tech components. Again export performance requirements could also be used without linking them to imports by investors. Furthermore, there are no restrictions over requirements for local procurement of services as part of entry conditions. Such policy options will remain open as long as developing countries make no commitment for unrestricted market access to foreign investors, including in the services sectors where the existing GATS regime provides considerable flexibility.[12]

[11] On the trade distorting effect of FDI subsidies and trade restricting policies of TNCs see Kumar (2002 and 2005).

[12] However, developed countries have been seeking to remove flexibility by changing the modalities of GATS negotiations– Khor (2006).

4. Transfer of technology

Both the agreement on industrial subsidies and investment-related disciplines discussed above constrain technology polices by prohibiting incentives and restrictions for promoting technological progress and upgrading to higher value-added products. The TRIPS agreement impinges directly on transfer of technology by providing extensive and global protection to innovators of knowledge. It establishes minimum standards that the countries are obliged to observe in establishing regimes for protecting intellectual property rights (IPRs) in a broad range of areas of which patents and, to a lesser extent, copyrights constitute the most important ones in terms of their implications for technology policies. Parties to the agreement are obliged to offer patents in almost all fields; give protection to owners of IPRs no less than the level provided in the agreement; apply national treatment to foreign owners of IPRs registered with them; and observe non-discrimination among foreign holders of IPRs.[13]

As many other WTO agreements, TRIPS too constitutes an attempt to kick away the ladder to prevent followers from catching up technologically by denying the opportunities widely exploited by today's industrial countries in the past. Indeed in most of today's industrially advanced countries patent rights had been introduced only at a late stage of development, and protection accorded to foreigners was exceptionally weak in order to allow nationals easy access to advanced technology (Chang 2001 and 2002; Bercovitz 1990; Gerster 2001; and Kumar 2003). TRIPS is the most unequal WTO agreement in terms of distribution of its costs and benefits between developed and developing countries since the former are mainly the producers and the latter users of technology. Despite that developing countries agreed to TRIPS during the Uruguay Round because of the expectation that they would obtain additional market access in industrial countries in agricultural products and textiles and clothing.

Since industrial upgrading becomes more demanding and imitation and adaptation of foreign technology gain added importance at intermediate stages of industrialization, the TRIPS

[13] For a detailed description of rights and obligations under the TRIPS Agreement see Das (1999: chap. VII.2), and Correa (1998 and 2000).

agreement places greater constraint on technical progress in middle-income than low-income countries – though not in terms of cost of vital products such as pharmaceuticals. By contrast, there is very little evidence supporting its claimed benefits, including acceleration of innovation in developing countries and greater spillovers of technology from developed to developing countries through increased FDI (Correa, 2000; Kumar 2003; and Maskus 2005).

However, there is still policy space. Several policies for technological capability-building at the firm level still remain outside the WTO disciplines (Rasiah 2005). More importantly, there are several flexibilities in the agreement which the developing countries could exploit by establishing appropriate national legislation and practices (TWN 1998; Correa 2000; and Shadlen 2005). The agreement leaves considerable discretion in the determination of eligibility for patenting, which allows developing countries to adopt a narrow concept of invention. It stipulates restrictions on the exercise of control by patent holders over their rights, requires disclosure to facilitate access to innovation, and allows governments to issue compulsory licences for patents registered with them if there are justifying circumstances including emergency and anti-competitive practices by the holder.

It is also equally important to secure agreement on certain interpretations of the provisions of TRIPS so as to enhance the freedom of developing countries in determining patentability and issuing compulsory licences. Here one of the key issues is to have the right to issue compulsory licences when the technology in question is not domestically applied. Issuance of compulsory licences on such basis is permitted by IPR regimes in Brazil and India, but the matter is contentious in the WTO (Shadlen 2005; and World Bank 2002: Box 5.2). This needs to be resolved to give more space to developing countries in technology policies.

D. Finance and macroeconomic policy

The second key area of public intervention circumscribed by global markets and multilateral rules and practices is macroeconomic policy. Here finance plays a key role. On the one hand financial markets exert considerable pressure on governments for liberalization, while on the other hand capital account openness and close integration into global financial markets restrict the ability of governments to pursue autonomous macroeconomic policy. Not only have financial markets become a major independent source of instability, but their procyclical behaviour promotes monetary and fiscal policies that aggravate rather than reduce macroeconomic instability. This is particularly true for highly indebted, financially constrained emerging markets.

Official financing, be it multilateral or bilateral, does not always help alleviate instability caused by procyclical behaviour of private financial flows. Emerging markets facing sudden and rapid exit of private capital often receive official assistance conditional on procyclical macroeconomic tightening. On the other hand evidence clearly shows that aid to low-income countries is highly volatile and procyclical, drying up where and when it is most needed, necessitating fiscal tightening at times when expansionary policies are called for. This could be even more damaging than instability caused by private capital flows to emerging markets since, compared to the latter, low-income countries have little scope to cope with instability in external financing. Gaining greater policy space for such countries depends crucially on the reform of international financial cooperation.

1. Capital account liberalization and monetary policy

It is generally recognized that capital account liberalization creates dilemmas in macroeconomic managements, particularly for monetary policy. According to mainstream economic theory policymakers cannot simultaneously pursue an independent monetary policy, control the exchange rate and maintain an open capital account. All three are *potentially* feasible but only two of them could be chosen as *actual* policy – thus, the dilemma known as impossible

trinity. Thus, once the capital account is opened, a choice has to be made between controlling the exchange rate and an independent monetary policy. Using monetary policy as a countercyclical tool to regulate and stabilize economic activity could result in large cyclical swings in the exchange rate and balance of payments. Conversely, if monetary policy is used for maintaining a pegged or fixed exchange rate, it cannot act as a countercyclical tool and prevent large cyclical swings in economic activity.

However, in most developing countries erosion of monetary policy autonomy is often greater than is typically portrayed in the mainstream economic theory. In these countries monetary policy cannot always secure macroeconomic and financial stability whether it is geared towards a stable exchange rate or conducted independently as a counteryclical tool. First of all, in modern financial markets the effect of monetary policy and policy interest rates over exchange rates is much more uncertain and unstable than is typically assumed in the theory of impossible trinity, because of volatile market sentiments and risk assessments. During financial turmoil hikes in interest rates are often unable to check currency declines while at times of favourable risk assessment a small arbitrage margin can attract large inflows of private capital and cause currency appreciations.

Second, the existence of large stocks of public and/or private debt in foreign currencies – the so-called liability dollarization– results in strong spillovers from exchange rates to domestic economic and financial conditions. While in industrial countries currency instability is rarely transmitted to balance sheets and domestic capital and credit markets, in developing countries domestic business and financial cycles are often associated with sharp swings in external capital flows and exchange rates.[14] Debt has become a much more important channel of transmission of exchange rate changes onto economic activity and stability than trade – the main channel of transmission in the traditional theory of impossible trinity. It is very rare that currency crises in developing countries are contained without having a significant impact on domestic financial conditions, balance sheets and economic activity. This is a main reason why about 85 per cent of

[14] Indeed the theory of impossible trinity is based on the Mundell-Fleming model developed primarily for advanced industrial countries where the extent of liability dollarization is limited. On its origin see Boughton (2003).

all defaults in developing countries during 1970-1999 were linked with currency crises (IMF 2002; Reinhart 2002).

The official advice to developing countries has been to assign monetary policy to price stability, often in the form of inflation targeting. This is based on the belief that price stability, together with fiscal discipline, would hold the key for rapid growth as well as securing macroeconomic and financial stability, including stability of income and employment, balance of payments, capital flows, interest rates, exchange rates and asset prices. However, such an advice has become increasingly untenable because in many developing countries success in securing price stability and fiscal discipline has not been followed by rapid and sustained growth. More importantly, in several emerging markets, notably in East Asia, boom-bust cycles in capital flows and gyrations in exchange rates, balance-of-payments, employment and economic activity have all occurred under conditions of price stability and fiscal discipline. In more extreme cases, as in Latin America, price stability has been bought at the expense of increased financial fragility and instability, through exchange-rate based stabilization programmes, relying on unstable capital flows.

The dilemmas faced by monetary policy have become more serious because fluctuations in economic activity are increasingly associated with capital-account cycles. Business cycles tend to be accentuated by procyclical behaviour of international lenders and investors which tend to add to economic upswings and generate fragility in countries they favour, but withdraw rapidly with the reversal of risk perceptions and deny access to international liquidity when it is most needed. Booms generated by improved opportunities for profitable investment lead to underestimation of risks, overexpansion of credits and over-indebtedness. The consequent build-up of external fragility and deterioration of balance sheets eventually lead to a reassessment of risks and cuts in international lending and investment, often resulting in financial meltdown and sharp contraction in economic activity.

Monetary policy on its own is quite powerless in managing business cycles associated with such surges and rapid exits of capital. This is because countercyclical monetary measures,

notably adjustments in policy interest rates, needed to stabilize economic activity often generate adverse influences on capital flows and exchange rates which, in turn, undermine stability and growth.

At times of booms, monetary tightening needed to check asset price bubbles and overheating encourages external borrowing and attract short-term arbitrage flows which, in turn, appreciate the currency and lead to a deterioration in the trade balance and build-up of external fragility. Prevention of such an outcome would call for intervention in the foreign exchange market in order to stabilize the currency. However, this runs up against a number of hurdles. If intervention is not sterilized, domestic liquidity will expand, fuelling inflation in asset and, possibly, product markets. The effects of capital flows on both the exchange rate and domestic liquidity can be successfully sterilized by issuing government or central bank debt when such flows are moderate in size and concentrated in the market for fixed-income assets. However, under strong surges across various segments of financial markets, sterilization would likely result in higher interest rates, attracting even more arbitrage flows.[15] Furthermore, since interest earned on reserves is usually much lower than interest paid on public debt, there will be fiscal (or quasi-fiscal) costs, which can be very large when interest rate differentials are wide and the surge in capital inflows is strong. There are less costly methods of sterilization such as raising the non-interest-bearing reserve requirements of banks. This would also raise the cost of borrowing from banks, thereby checking domestic credit expansion. However, it could also encourage firms to go to foreign creditors. Banks may also shift business to offshore centres and lend through their affiliates abroad, particularly in countries where foreign presence in the banking sector is important.

[15] In Argentina where capital flows have been relatively moderate, sterilization seems to have been successful in keeping the real exchange rate within range and absorbing resulting excess liquidity through emission of central bank paper since 2002-2003 despite opposition from the IMF– see Damill, Frenkel and Maurizio (2007). China's apparent recent success in sterilizing large inflows of capital is due, at least in part, to its control over the domestic financial system ("financial repression") which helps to keep interest rates low despite rapid economic expansion. On intervention in China see Goldstein and Lardy (2005); and controversies over the effectiveness of foreign exchange market interventions Sarno and Taylor (2001).

Monetary policy faces even greater dilemmas when capital flows are reversed and economic contraction sets in. Monetary expansion and cuts in interest rates needed to prevent credit crunch and financial meltdown and to stimulate economic activity would accelerate flight from the currency. Monetary authorities are thus compelled to pursue procyclical policy in an effort to restore the confidence of the markets. However, under crisis conditions the link assumed in the traditional theory between the interest rate and the exchange rate breaks down. When the market sentiment turns sour, higher interest rates aiming to retain capital tend to be perceived as increased risk of default. As a result, the risk-adjusted rate of return could actually fall as interest rates are raised. This is the main reason why procyclical monetary policy and interest rates hikes implemented as part of IMF bail out operations during several episodes of financial crises in emerging markets were unable to prevent the collapse of the currency, serving instead to deepen economic contraction.

Even though there are technical difficulties in empirically measuring the stance of monetary policy, particularly in identifying the policy component as opposed to endogenous component of monetary policy, available evidence clearly shows that they are almost always procyclical at times of economic downturns associated with a rapid exit of capital. On the other hand, during booms the stance of monetary policy varies among countries because of the dilemmas noted above. In general, recent years have seen both excessive tightening of monetary policy to bring inflation under control and several episodes of credit boom associated with surges in capital inflows (Mohanty and Scatigna 2003: 52-55 and table 7). Some evidence indeed shows that policy rates are lowered in goods times (Kaminsky, Reinhart and Végh 2004). This would have a procyclical effect on economic activity even though it would discourage arbitrage flows. But a more common practice in financial constrained, high-inflation economies is to tighten monetary policy and raise interest rates during booms. This helps reduce inflation without cutting growth by encouraging arbitrage flows and appreciating the currency, but it also leads to a build-up of external debt and fragility which often ends up in a hard landing of the

currency, necessitating procyclical tightening and leading to large losses of output and employment.[16]

2. Public finance, debt and fiscal policy

While constraints imposed by capital account openness on monetary policy are generally recognized, little attention has been paid to the implications of financial liberalization in general and capital account openness in particular for the scope and effectiveness of fiscal policy as a tool of macroeconomic management. In fact fiscal policy has become even more procyclical than monetary policy as a result of rapid accumulation of public debt and increased dependence of fiscal space on volatile conditions in financial markets.

The past two decades have seen a rapid shift in the financing of budget deficits in developing countries from central banks towards financial markets – that is, from direct to indirect financing – together with deregulation of interest rate regimes. This was advocated, *inter alia*, on grounds that market discipline over public borrowing would help bring fiscal responsibility and macroeconomic stability. Instead, there has been a rapid accumulation of public debt in many emerging markets as bond issues have replaced money printing.

The process of debt accumulation has been greatly facilitated by the liberalization of the capital account. In several countries closing the fiscal gap, rather than the forex gap, has become a major objective of capital account liberalization since domestic financial markets are not deep enough to absorb rising public debt. This has allowed residents, notably banks, to engage in international arbitrage in search for high profits on investment in public debt while assuming considerable exchange rate risks. It has also allowed non-residents to acquire government paper in domestic markets. Further, residents who traditionally invested in real assets such as gold and property as inflation hedges have been encouraged to lend to the public sector by linking government debt to the exchange rate. Consequently, an important part of domestic currency

[16] This was the case in Latin America in the 1990s where monetary conditions were tighter and more volatile in comparison with East Asia: see UNCTAD TDR (2003: 132-136).

debt has come to be held by non-residents and of dollar-denominated (or linked) debt by residents, and the distinction between external and domestic debt has lost its significance.

Despite the emphasis by financial orthodoxy on fiscal discipline, the process of public debt accumulation has continued unabated. Average public debt in emerging markets now hovers around 65 per cent of GDP despite highly favourable global financial conditions in the past few years (IMF 2006a: 16). External sovereign debt as a proportion of GDP now exceeds the levels of the 1980s. Although in recent years growth in external debt has declined in Latin America and stayed relatively stable in Asia, there has been considerable increase in domestic debt in both regions (IMF 2003b: chap. 3).

Much of this increase is accounted for by sharp movements in interest and exchange rates and excessive borrowing by some governments during surges in capital inflows. In some countries a more important factor has been the assumption of private liabilities by the public sector – socialization of private debt –, mainly through recapitalization of insolvent banks, at times of financial crises. In Indonesia, for instance, such operations raised public debt by more than 50 per cent of GDP (IMF 2003a: 28n), creating problems of fiscal sustainability despite a good track record regarding fiscal discipline.

Consequently, stabilizing and sustaining public debt without running into arrears and defaults or facing drastic fiscal adjustments has become the principal occupation of treasury departments of financially constrained, highly indebted emerging market economies. Almost all other possible objectives of fiscal policy are subordinated to debt management. In several such countries, interest payments from the budget as a proportion of GDP have been several times the public investment in physical and human infrastructure. In Turkey, for instance, during 2002-2004 public investment as a proportion of GDP averaged at around 2 per cent of GDP while interest payments from the budget stood at some 16 per cent (ISSA 2005: table 12).

Not only has the accumulation of public debt reduced fiscal flexibility and increased its vulnerability to rapid shifts in financial market conditions, but it has also promoted procyclical

fiscal policy. It is generally agreed that an appropriate fiscal response at times of booms associated with surges in capital inflows should be budgetary tightening. This could not only moderate expansion in domestic demand but also help, through budgetary surpluses thus generated, to absorb excess inflow of foreign capital without encountering the type of difficulties in monetary sterilization noted above.[17] Similarly at times of rapid exit of capital and financial turbulence and economic contraction, countercyclical response would call for fiscal expansion, primarily through increases in spending, combined with monetary accommodation to avoid increases in interest rates.

However, this is rarely the policy response in economies with large stocks of public debt and a history of price instability. At times when risk assessment is unfavourable, there is very little scope for the public sector to increase spending because of potential adverse reaction of financial markets. In fact, as in monetary policy, governments are often compelled to pursue procyclical fiscal policy during rapid exit of capital and economic contraction in order to enhance their credibility with markets and check capital flight. By contrast the scope for fiscal expansion increases when market assessment turns favourable – surges in capital inflows do not only facilitate borrowing but raise fiscal revenues by accelerating growth. Thus, procyclical behaviour of capital flows encourages and even dictates procyclical fiscal policy.

There is ample evidence showing that fiscal policy in emerging markets has generally been much more procyclical than monetary policy, adding to expansion and bubbles during financial booms and to deflation during busts.[18] This is particularly the case in Latin America. Fiscal expansion at times of boom usually takes the form of cuts in taxes and increases in spending while expenditures are almost invariably reduced during downturns. Fiscal tightening

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[17] The Keynesian theory of financial boom-bust cycles as developed by Minsky (1986) favour such an action because of its stabilizing effects on aggregate demand. It is also recommended by the IMF to emerging markets because it would help avoid currency appreciations and balance of payments deterioration; see Akyüz (2005b).

[18] See a number of papers in BIS (2003). See also Kaminski, Reinhart and Végh (2004) and United Nations (2006: chap. IV). For a further discussion see Akyüz (2006: 43- 47).

was also the response to the financial crisis in Asia, implemented as part of IMF programs. However, Asian countries have often been able to respond to weaknesses in global demand and slowdown in export earnings by fiscal and monetary expansion– a space that does not exist in financially constrained economies of Latin America and Africa.

3. Aid and macroeconomic policy

Low income countries are more vulnerable to balance of payments instability arising from fluctuations in commodity prices and export earnings than boom-bust cycles in private capital flows even though with their growing integration into international financing markets, private flows have increased in importance for these countries as well. Because of procyclical behaviour of international financial markets, their access to short-term liquidity and trade credits are often curtailed at times of adverse movements in commodity prices and terms of trade. This provides the main rationale for multilateral lending, notably provision of liquidity by the IMF, to enable them to weather temporary adverse movements in balance of payments without suffering from large losses of output and employment.[19]

However, these countries are often compelled to pursue procyclical macroeconomic policies by conditionalities attached to access to IMF resources beyond the gold tranche. Rather than providing adequate liquidity to meet export shortfalls, the Fund is inclined to impose exactly the kind of policies that the architects of the Bretton Woods system wanted to avoid in countries facing temporary balance of payments difficulties – that is, adjustment through austerity. Macroeconomic retrenchment is demanded irrespective of whether such difficulties are due to excessive domestic spending, distortions in the price structure, or external disturbances such as terms of trade shocks, hikes in international interest rates or trade measures introduced by another country.[20]

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[19] On the rationale of multilateral lending see Akyüz (2005a).

[20] For instance the Compensatory Financing Facility (CFF) introduced in the early 1960s to enable countries facing temporary shortfalls in primary export earnings to draw on the Fund beyond their normal drawing rights without the performance criteria normally required for upper credit tranches has subsequently been translated into a conditional facility (Akyüz 2005b).

More generally, evidence strongly suggests that aid is highly unpredictable. It is as volatile as private capital flows to emerging markets and its volatility increases with aid dependence (UN 2005: chap. IV; World Bank 2005: chap. 5; and Hill 2005). There is also evidence that multilateral flows are relatively more volatile than their bilateral counterparts (Pallage and Robe 2001). According to the World Bank (2005) aid flows to poor countries have become more volatile over 1990-2002 than in earlier years and most other flows. A more recent paper from the IMF finds no evidence of any fundamental change in the way aid has been delivered after the introduction of poverty reduction initiatives, despite the declared aim of strengthening coordination among donors and improving the design of financial support programs. Indeed it finds that aid volatility has worsened somewhat and concludes that the main causes of the volatility and unpredictability of aid, and the broader issue of macroeconomic instability in low-income countries, have not been addressed in a systematic manner by the donor community (Bulir and Hamann 2006).

In general aid flows are more volatile than either output or fiscal revenues. Consequently, they tend to aggravate rather than stabilize fluctuations in output and public spending. More importantly, they are procyclical, correlated with growth in output and fiscal revenues in recipient countries.[21] According to evidence provided by Pallage and Robe (2001) this is particularly the case in Africa. It is also found in the same study that for almost all HIPCs aid flows were procyclical between 1969 and 1995.

The significance of procyclicality of aid for fiscal policy space derives from the strong connection between the budget and aid flows in low-income countries. The dependence of the budget on aid has in fact increased as trade liberalization has eroded tax revenues and increased financial openness has dictated more liberal tax-treatment of capital incomes.[22] When aid flows diminish at times of declines in output and budget revenues as a result of, say, terms of trade

[21] See Pallage and Robe (2001) for volatility and procyclicality with respect to output, and Bulir and Hamann (2003), Bulir and Lane (2004) and Hill (2005) with respect to fiscal revenues. For a theoretical attempt to explain procyclicality of aid see Cordella, Dell'Ariccia and Keltzer (2002).

[22] Many low-income countries dependent on trade taxes have been unable to recover the revenues lost from trade liberalization through other means such as value-added taxes; see Baunsgaard and Keen (2005).

shocks, fiscal policy would need to be tightened, adding to economic contraction. Again, there are occasional surges in aid flows to countries enjoying relatively rapid growth, and these create similar problems of sterilization and macroeconomic management as in emerging markets facing surges in private inflows.[23]

4. Impact on growth and development

It is generally agreed that persistent macroeconomic instability impedes growth and development. As noted above, rather than stabilizing economic activity at levels close to its potential, macroeconomic policies in most developing counties tend to add to instability. The link between instability and growth derives primarily form the effect of uncertainty on investment decisions. Sharp swings in key prices including interest rates, exchange rates and real wages, and instability in output and income increase the risks associated with long-term, illiquid investment decisions, shorten time horizons and promote defensive and speculative investment strategies.[24] These in turn not only lower the average level of investment over the business cycle but also distort its allocation at the expense of socially productive capital.

Indeed empirical evidence strongly suggests that long-term growth is adversely affected by output fluctuations, and that the adverse impact of volatility on growth is stronger in countries with a low degree of financial development.[25] While countercyclical polices have a positive influence on growth (Aghion and Howitt 2005), there appears to be an inverse relationship between cyclicality of fiscal policy and economic growth in developing countries (UN 2006: chap. IV). There is also evidence that financial liberalization tends to aggravate the trade-off

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[23] For the experience of Uganda in this respect see Schneider (2006).

[24] For investment under uncertainty see Dixit and Pindyck (1994). On the relation between macroeconomic instability and growth see Fischer (1993) and Bleaney (1996).

[25] On the relation between macroeconomic instability and growth see Fischer (1993); Bleaney (1996); Ramey and Ramey (1995), and Aizenman and Pinto (2005). On the link between financial development and the impact of volatility on growth see Aghion *et al*. (2005).

between growth and output volatility in emerging markets.[26] Aid uncertainty, as measured by deviations of disbursements from expected inflows, is found to reduce its positive impact on economic growth in recipient countries (Lensink and Morrissey 2000).

Evidence also shows that output volatility is much higher in emerging markets than in advanced industrial countries – and it is still higher in low-income countries. On some estimates, volatility of real GDP growth in emerging markets, as measured by standard deviation, is double that for industrial countries (Catão and Kapur 2004; Kaminsky, Reinhart and Végh 2004; Hostland and Karam 2005). Again within the developing world, GDP growth volatility is higher for African countries (Pallage and Robe 2001). This reflects not only the greater vulnerability of developing countries to external shocks, but also their limited ability to respond to them by countercyclical macroeconomic policies.

Except for low-income countries heavily dependent on commodity exports, external financial shocks have become a much more serious source of disruption in the developing world than fluctuations in volumes and terms of international trade. There is increased evidence that boom-bust financial cycles in developing countries cause permanent dislocations in the long-term growth path and the labour market. Over the entire boom-bust-recovery cycles, there is often net loss of output, employment and wage incomes. Booms can lift income, employment and wages above their long-term levels, but crises depress them significantly on a more durable basis. In recoveries from deflation-*cum*-recessions, both employment and wages tend to lag considerably behind income growth. While jobless recoveries are a common feature of emerging markets recovering from financial crises and industrial countries such as the United States recovering from burst of financial bubbles, their implications for labour market are more serious in developing countries.[27]

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[26] For instance Kose, Prasad and Terrones (2005: 59) find that "financial integration … seems to strengthen the negative relationship between growth and volatility" but de-emphasize this finding.

[27] For the impact of boom-bust cycles on output, wages and employment see UNCTAD TDR (2000: chap. 4) and Van der Hoeven and Lübker (2005). On jobless recoveries from financial crises see Akyüz (2006: 56-60)

5. Space for autonomous national policy

There is considerable variation among developing countries in the extent to which they experience constraints over macroeconomic policies due to volatile and procyclical capital flows. Here differences in the degree of capital account openness and features affecting financial fragility including savings, foreign exchange and fiscal gaps, dependence on foreign capital, and the extent and nature of liability dollarization play key roles. These differences result partly from policy choices and partly from structural characteristics.

Low-income countries dependent on official financing have very little scope to reduce their susceptibility to volatility and procyclicality of aid by their own policy action, even though they may have some room to mobilize domestic resources in order to reduce their chronic savings, balance-of-payments and fiscal gaps. For these countries, widening the space for macroeconomic policy depends very much on multilateral initiatives to secure greater predictability and stability of aid flows.

Since there is no multilaterally agreed regime for international capital flows, developing countries generally have *de jure* autonomy in capital account policies, even though some of them have undertaken obligations in bilateral or regional agreements. However, their *de facto* control is limited because of pressures for financial liberalization from multilateral financial institutions, domestic and international financial markets, and certain major industrial country governments.[28] In reality, there is considerable diversity in capital account regimes in the developing world. According to an index of financial openness, in the second half of the 1990s financial system in some developing countries including Argentina and Mexico was more open than the United Kingdom and the United States, while several others such as India and Malaysia came at the bottom of the list as economies with largely closed capital accounts (Dailami 2000: table 15.3). Voluntary and deliberate policy choices are certainly an important part of the explanation of this diversity.

[28] Although the Washington Consensus in its original form and IMF country programs did not include capital account liberalization (Williamson 2003), the Washington ideology was very much in favour of it– Akyüz (2005b).

Many heavily indebted emerging-market economies with chronic fiscal, savings and balance-of-payments gaps – and hence with a relatively high degree of financial fragility – have been more willing to open up their capital accounts in order to find quick fixes to these deep-seated problems than some of the countries with sound fiscal and balance-of-payments positions.[29] This perhaps reflects the recognition, on the part of the latter countries, that fiscal and monetary discipline and sound payments positions cannot always prevent financial instability and crises if a hands-off approach is adopted towards capital flows. As the Asian crisis shows, when policies falter in managing integration and regulating capital flows, there is no limit to the damage that international finance can inflict on an economy.

In order to reduce vulnerability to volatile capital flows and enhance the space for autonomous macroeconomic policy, most emerging-market economies may need to act on three fronts: introduce built-in financial stabilizers to reduce the cyclicality of the domestic financial system; regulate and control capital inflows in order to check surges driven by short-term international arbitrage opportunities, prevent overvaluation, rising trade deficits and build-up of external financial fragility; and use, when necessary, temporary standstills and exchange controls at times of sharp cutbacks in international lending and investment and rapid exit of capital, in order to contain currency declines and financial meltdown, and to gain space for countercyclical macroeconomic expansion.

In discussing the policy problem in the financial boom-bust cycles, Minsky (1986) starts from the proposition that "stability – or tranquillity – is destabilizing" because it increases confidence of borrowers and lenders, and lowers safety margins. This is yet another instance of market failure that provides a strong rationale for the government to establish a system of financial control to promote stability. There is indeed consensus on the need for prudential regulations and effective supervision of the financial system, but much less agreement on how these should be designed. An important lesson from recent bouts of financial instability in both developing and developed countries is that many of the traditional risk assessment methods and

[29] For the Latin American experimentation with neo-liberalism see UNCTAD TDR (2003: chap. VI).

prudential rules may simply serve to amplify the cyclicality of the financial system. Rules such as loan-loss provisions and capital requirements are relatively easy to meet in good times when loan delinquency is low and asset values are inflated. As a result, booms give rise to inadequate provisioning and excessive credit expansion and over-indebtedness, but when the down-turn comes, and loan delinquency rises and asset prices fall rapidly, the application of such rules can lead to a credit crunch.

One way of dealing with these problems is to design prudential regulations in such a way that they provide built-in stabilizers to limit the cyclicality of the financial system (BIS 2001; chap. VII). Forward-looking rules may be applied to capital requirements in order to introduce a degree of countercyclicality. This would mean establishing higher capital requirements at times of financial booms, based on estimation of long-term risks over the entire financial cycle, not just on the actual risk at a particular phase of the cycle. The same principle can be applied to provisioning. For instance Spain has been using a forward-looking system whereby not current but future losses are taken into account in making loan-loss provisions, estimated on the basis of long-run historical loss experience for each type of loan. Again, long-term valuation may be used for collaterals in mortgage lending in order to reduce the risks associated with ups and downs in property markets. This is practised in the EU where property valuation in mortgage lending reflects long-term trends in the market for real estate. Finally, other measures affecting conditions in credit and asset markets, such as margin requirements, could also be employed in a countercyclical manner, tightened at times of boom and loosened during contractions.

While useful in containing the damage that may be inflicted by financial crises, none of these measures could adequately deal with risks associated with sharp swings in capital flows and exchange rates. Such risks can be restricted by applying more stringent rules to banks' foreign exchange liabilities in capital adequacy requirements, loan-loss provisions, and liquidity and reserve requirements. Currency mismatches can be prohibited and restrictions can be applied to maturity mismatches between foreign exchange assets and liabilities of banks with a view to preventing borrowing short in international markets and lending long at home. Banks can also be prevented from lending in foreign currency to sectors without foreign exchange

earning capacity. Taxes and non-interest bearing reserve requirements can be used to reduce arbitrage margins when domestic rates are considerably higher than rates abroad.

These and many other techniques of regulation and control over capital flows were widely used by industrial countries in the postwar period.[30] In fact in several major industrial countries including Japan, France and Italy, such restrictions were lifted only in the past two decades. By contrast, many developing countries have moved rapidly towards a regime of open capital accounts before reaching industrial and institutional maturity.

There have been only a few attempts in emerging markets in recent years to curb surges in capital inflows through effective use of capital account measures. One such experiment was in Malaysia during 1994 when direct quantitative restrictions were imposed on the acquisition of short-term securities by non-residents. Empirical research suggests that these restrictions were effective in improving external debt profile, preventing asset-price bubbles, and allowing greater space for macroeconomic policy. By contrast Chile used a price-based measure, unremunerated reserve requirements, in a countercyclical manner, applied to all loans at times of strong inflows in the 1990s, but phased out when capital dried up at the end of the decade. These measures were effective in improving the maturity profile of external borrowing, but not in checking aggregate capital inflows, pressures for appreciation and asset-price bubbles, as in Malaysia.[31]

More recently, at the end of 2006, Thailand imposed a 30 per cent unremunerated reserve requirement on capital inflows held less than one year, including portfolio equity flows, in order to check continued appreciation of its currency. This provoked a strong reaction from the stock market, forcing the government to exempt investment in stocks from reserve requirements, but retaining on bonds and other debt instruments. While this was portrayed as a retreat in the financial press, exceptions granted to FDI or portfolio equity flows do not necessarily remove the policy space gained by imposing explicit or implicit taxes on arbitrage flows, provided that the tax rate is adjusted to eliminate the margin between domestic and dollar rates. This is because,

[30] See, e.g. a number of articles in Swoboda (1976).

[31] For a discussion and assessment of these measures see Ocampo (2003).

unlike fixed-income flows, countercyclical monetary tightening would not generate destabilizing effects by encouraging FDI and portfolio equity flows. Higher interest rates would in fact discourage them by lowering both current incomes and discounted expected earnings of corporations. Besides, since in direct and portfolio equity investment the currency risk is assumed by international investors, the adverse domestic financial repercussion of an eventual correction in the exchange rate would be limited.

Finally, consideration should be given to using temporary controls on outflows at times of rapid exit of capital. The policy response to financial crises in emerging markets, as noted, have almost always involved procyclical monetary and fiscal tightening, combined with IMF bailout operations designed to keep countries current on their debt payments to private creditors, to maintain capital account convertibility and to prevent default. Such a response not only fails to prevent financial meltdown and sharp contraction in output and employment, but also allows creditors and investors to escape the consequences of the risks they take and shift the burden onto debtors. Under these circumstances temporary debt standstills and exchange controls can be the only viable option. This has also been recognized by the IMF Board which argued that "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally", and that since "there could be a risk that this action would trigger capital outflows … a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls" (IMF 2000). Such an action would not only allow the country to implement countercyclical monetary and fiscal policies for a swift recovery, but also facilitate, when needed, to restructure debt so as to share the burden equitably between debtors and creditors.[32]

[32] Debt restructuring could also be facilitated by the inclusion of collective action clauses into international bond contracts. For a detailed treatment of these issues see Akyüz (2002b).

So far a step along these lines was taken only by Malaysia with considerable success during the 1997 Asian crisis.[33] All other countries hit by crises including Korea went along with the IMF programs, maintaining open capital accounts and applying procyclical macroeconomic policies. However, the Korean government recognized in a subsequent assessment that "many of those who have analysed Korea's 1997–1998 crisis contend that Korea could have been solved its liquidity problems sooner had a standstill mechanism been in place at the time it requested IMF assistance" (G-20 1999: 13).

6. Reform of the international monetary and financial system

There are several important shortcomings in the international monetary and financial architecture and a comprehensive review of these would go beyond the scope of this paper.[34] Here attention is focussed on three areas where effective reforms can play a crucial role in enhancing macroeconomic policy autonomy in developing countries: capital account measures, policy surveillance, and official financing.

a. Capital account measures

While the articles of the IMF recognize the right of its members to regulate international capital flows and allow the Fund to request them to exercise control on capital outflows, they do not provide legal protection against litigation by international investors and creditors for countries imposing temporary standstills and exchange controls at times of rapid exit of capital.[35] With recurrent crises in emerging markets and the problems associated with IMF rescue packages and procyclical policies, there has been an increased recognition of the need for orderly debt workout procedures, including officially sanctioned temporary standstills and controls on

[33] On the rationale and effectiveness of Malaysian capital controls see UNCTAD TDR (2000: chap. IV). See also Kaplan and Rodrik (2001).

[34] For a detailed discussion of these issues see Akyüz (2002a) and the literature cited therein.

[35] On conflicting interpretations of IMF provisions and judicial practices see UNCTAD TDR (1998: chap. IV).

outflows. However, as noted, while recognizing the need for standstills, the Fund has not been able to move in this direction in large part because of opposition from the financial markets and some major governments. The proposal prepared by the Fund secretariat for Sovereign Debt Restructuring Mechanism (SDRM) did not include statutory protection against litigation while giving considerable leverage to bondholders. Even in this diluted form it has been put on the backburner, as the impetus for reform has been lost because of widespread complacency with the recovery of capital flows to developing countries.[36]

According to a recent report by the Independent Evaluation Office "the IMF has learned over time on capital account issues" and "the new paradigm … acknowledges the usefulness of capital controls under certain conditions, particularly controls over inflows", but this not yet reflected in policy advice because of "the lack of a clear position by the institution" (IMF/IEO 2005: p. 11). Therefore, reform in the area of multilateral arrangements for capital account regimes should seek not only to include restrictions over capital outflows as legitimate tools of policy in the context of orderly debt workout procedures, but also specify the conditions under which the Fund should support or recommend the imposition or strengthening of controls over capital inflows in order to avoid unsustainable payments imbalances and build-up of external financial fragility.

b. Policy surveillance

As noted, international monetary and financial stability is a major concern to developing countries because of their vulnerability to external financial shocks. Such shocks are often connected to large shifts in exchange rate and macroeconomic policies in major industrial countries. The sharp rise in the United States interest rates and the appreciation of the dollar was a main factor in the debt crisis of the 1980s. Likewise, the boom-bust cycle of capital flows in the 1990s which devastated many developing countries were strongly influenced by shifts in

[36] Initially the Fund secretariat had also advocated temporary standstills and exchange controls to facilitate debt workouts – see Krueger (2001: 7). For a detailed discussion of the rationale for orderly debt workouts and the debate in the IMF see Akyüz (2005b: chap. 5).

monetary conditions in the United States and the exchange rates among the major reserve currencies (UNCTAD TDR 1998: chap. IV; and 2003, chap. II). Again, despite exceptionally favourable conditions in global financial markets over the past few years, persistent global payments imbalances and uncertainties surrounding exchange rates of major currencies now pose serious threat to stability in developing countries.

So far neither IMF surveillance nor consultations within the G7 have been effective in securing appropriate mix and stance of macroeconomic policies in leading economies, and removing global payments imbalances and currency misalignments. The failure in policy coordination underlines the recent decision of the Fund to initiate a new collective action by supplementing its surveillance consultations with individual members with multilateral consultations involving major actors including the United States, Japan, the European Union, China, Saudi Arabia and other so-called "systemically important countries" (IMF 2006b). Whether or not this initiative would be more successful in securing coordination remains to be seen, but the first signs are not very encouraging because of reluctance by some leading countries to fully engage in these consultations. Compared to these efforts, tasks to be undertaken for "an orderly unwinding of global imbalances" are formidable: "steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries" (IMF 2006c: para 7). This is all the more reason why developing countries need to be vigilant about international capital flows, and put in place self defence mechanisms until effective multilateral arrangements are introduced.

c. Official financing

Increased predictability and reduced procyclicality of official financing would not only improve its effectiveness but also facilitate macroeconomic management in recipient countries. One aspect of the problem concerns provision of international liquidity by the IMF to countries

facing temporary payments difficulties. Greater predictability could be secured by increasing unconditional access to Fund resources through reserve tranche purchases. This could be achieved by an overall expansion of Fund quotas and its redistribution in favour of poor countries. It also makes sense to separate quotas for contributions from those for drawing rights and set different access limits to different groups of countries according to their vulnerability to external shocks and access to financial markets. In conditional access beyond the reserve tranche, a better balance needs to be established between financing and macroeconomic adjustment depending on the nature of the disequilibrium. No structural condition should be attached to access to the Fund's general resources, as stipulated in the original guidelines.[37] The CFF should be revived as a low-conditional facility for countries facing temporary shortfalls in primary export earnings. Similarly, consideration should be given to introducing a global countercyclical facility, such as the two oil facilities established in the 1970s to prevent oil price hikes from triggering global recession, to be used, *inter alia*, at times of hikes in international interest rates and drying up of private flows to developing countries.

Second, development aid also needs to become less volatile and procyclical. Various proposals have already been put forward for better donor coordination and reduced structural conditionality in the provision of aid. Attention is focussed particularly on the International Finance Facility proposed by the British government, to be created by an international treaty.[38] Its objective is, *inter alia*, to secure long-term pre-commitment to provide funds for disbursements through the existing bilateral and multilateral aid-delivery channels. As formulated, such a facility would bring greater predictability of aggregate aid funds, but whether it would reduce volatility and procyclicality of aid flows to individual recipients would depend how it would be disbursed. In this respect recent shifts away from aid conditionality by some donors including the United Kingdom and Norway are particularly encouraging.[39]

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[37] See Akyüz (2007) for further discussion.

[38] HM Treasury (2003). For assessment see World Bank (2005) and Mavrotas (2005).

[39] See TWN (2006) and UN (2005).

Since poverty reduction has been declared as a global public good in several UN summits and conferences in recent years, there is a strong rationale for going a step further and establishing global sources of funds for development finance. This could be achieved through agreements on international taxes, including a currency transactions tax (the so-called Tobin tax), environmental taxes and various other taxes such as those on arms trade, to be applied by all parties to the agreement on the transactions and activities concerned and pooled in the UN development fund.[40] A common feature of these is that they are all sin taxes, which would provide revenues while discouraging certain *global public bads* such as currency speculation, environmental damage or armed conflict and violence. Certain sources of revenue, such as Tobin tax, would require universal participation, but others including environment taxes could be introduced on a regional or plurilateral basis. An advantage of such arrangements over present aid mechanisms is that once an agreement is reached, a certain degree of automaticity is introduced into the provision of development finance without going through politically charged and arduous negotiations for aid replenishments and national budgetary processes often driven by narrow interests.

E. Conclusions

Closer global economic integration and proliferation of multilateral rules and international obligations has resulted in tightened constraints over policy autonomy in developing countries. The WTO rules and obligations and structural conditionalities of the BWIs are the main factors restricting autonomy in development policy and strategies. Financial market pressures brought about by increased mobility of capital and capital account liberalization, macroeconomic conditionalities of the BWIs and procyclical behaviour of aid play a greater role in circumscribing monetary, fiscal and exchange rate policies. Bilateral and regional agreements bring constraints to both development and macroeconomic policies, and often these are much tighter than those resulting from multilateral rules and obligations.

[40] See Atkinson (2005) for such sources of development finance.

A second conclusion is that the multilateral system lacks coherence; that is, comparable and consistent disciplines in closely connected areas of international economic interaction. This is particularly notable between trade and finance. The existing system of global economic governance lacks effective multilateral disciplines over exchange rate, macroeconomic and financial policies, or for redress and dispute settlement regarding the negative impulses generated by such policies. In this respect, governance in money and finance lags behind that for international trade. This is a main source of strains in the trading system.

Third, there are significant inequalities between developed and developing countries in the way their policies are effectively constrained by multilateral arrangements. The choice of areas brought under multilateral disciplines and the design of rules and practices in these areas generally favour industrial countries. Lack of effective multilateral rules and obligations in macroeconomic and exchange rate policies is one important aspect of this asymmetry since it allows policies in richer and more powerful countries to escape multilateral oversight. By contrast, poor countries face strict conditionalities as part of their terms of access to official financing, which shape not only their exchange rate and macroeconomic policies but also broader development strategies. The WTO rules not only favour more advanced countries, as in the case of TRIPs, but also deny many instruments of development policy extensively used by advanced countries in reaching their current levels of industrialization.

Fourth, there still remains more space than is sometimes believed in both development strategies and financial and macroeconomic policies. In several areas brought under the WTO legislation there is room for manoeuvre. On the other hand many areas of policy remain outside existing multilateral legislation, including not only exchange rate and capital account regimes but also development-policy issues such as FDI, competition policy, and labour and environment standards. The degree of autonomy in these areas is greater for those middle-income countries that can escape donor conditionality than poor countries dependent on aid.

Fifth, differences among countries in the extent to which they are subjected to market pressures and multilateral disciplines, as well as in their willingness to accept the neoliberal

recipes explain why there is still considerable diversity in development strategies and macroeconomic and exchange rate policies within the developing world, even allowing for the convergence that has taken place towards outward-oriented, market-based strategies and greater financial orthodoxy over the past two decades. This is particularly the case in financial and exchange rate policies. However, there is also diversity in other areas of policy including tariff regimes as indicated by large inter-country variations in both applied and bound tariffs. Again, while some countries pursue an open door policy for FDI others are more selective. Technology policies, including R&D subsidies, are seen as a key instrument of upgrading in more dynamic economies whereas in others unbridled competition is expected to settle the matter.

What is to be done? Given the complexities of the issues involved, it would be difficult to write a blueprint for reform at the international or national level. Nevertheless, some broad conclusions emerge. First, there is a need to restructure multilateral disciplines to bring greater coherence and to widen boundaries of policy intervention for development. This calls for a fundamental reform of the international monetary and financial system. It also calls for a redesign of the WTO so as to incorporate greater space and flexibility for development policy into the rules rather than allowing them as exceptions– some specific proposals are made to that effect in the areas examined above. Secondly, there is a need for a rethinking the policy approach in many developing countries – to make use the policy space that is available, to create conditions for gaining additional space by reducing dependence on aid and private capital inflows, and to rely on innovative thinking rather than following one-size-fit-all prescriptions.

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