

## RICHARD T. ELY LECTURE

# Globalization and Its Challenges

By STANLEY FISCHER\*

I stand here with deeply conflicting emotions. I am honored to be delivering this prestigious lecture. I am profoundly sad that Rudi Dornbusch, who should have delivered the Ely Lecture, died in July last year and that I am here in his place. So I would like to start by talking about Rudi.

Rudi was born and grew up in Krefeld, Germany. He was an undergraduate at the University of Geneva and completed his Ph.D. at the University of Chicago in 1971, which is where we met. He was a student of Robert Mundell, and both the subject matter (the development of the Mundell-Fleming model) and the elegance and insights of his early work reflected Mundell's influence. He taught at the University of Rochester and at the University of Chicago before accepting an offer from MIT in 1975.

In 1976, soon after coming to MIT, Rudi wrote his most famous and influential theoretical article, "Expectations and Exchange Rate Dynamics." As Ken Rogoff (2002 p. 1) said in his celebratory lecture on the 25th anniversary of its publication, "The 'overshooting' paper... marks the birth of modern international macroeconomics."

From the late 1970's, Rudi became increasingly interested in policy issues. Within a decade, he had become one of the outstanding

policy economists of our time. In his policy work he displayed the same rare talent as he had in his theoretical work, of being able to extract the essence of a complicated problem and explain it in terms that made it seem simple. Among his policy papers, the most famous is the 1994 Brookings paper with Alejandro Werner that predicted the Mexican peso crisis, but that is only one of many applied papers that repays rereading.

As his policy interests grew, Rudi's fame spread. He was an indefatigable global traveler, speaker, and writer, and a frequent columnist. In his more popular articles, in his columns, and on the podium, his wit and the speed of his mind made him an exciting and formidable presence. He was one of the finest debaters and polemicists in the profession. He was tough and did not shy away from stating his views, often in ways that reflected the advice of Keynes: "Words ought to be a little wild for they are the assault of thoughts on the unthinking." At various times he was persona non grata to the authorities in a number of countries; it did not help that more often than not he was right.

Despite his public persona, Rudi was an excellent confidential policy adviser. When I was at the IMF, I often called him to discuss a difficult situation. His advice was always thoughtful, typically nuanced, and frequently provided insights that no one else had seen—and he was willing to talk as long as it took.

Rudi played a central role in the MIT Economics Department. He was a spectacularly successful teacher, in the classroom, in supervising theses, and through his textbooks. But he did not spoonfeed the students, sometimes positioning himself in front of an unfortunate student, asking a series of questions until he extracted an answer. Nonetheless he won many prizes for teaching. Every outstanding American international macroeconomist who has been

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to MIT, among them Jeffrey Frankel, Paul Krugman, Maurice Obstfeld, and Ken Rogoff, was a Rudi student. And there are outstanding Rudi students all over the globe, many of them here tonight, many of them professional economists, some who became Rudi's co-author on a paper, many who became policymakers. In the richly deserved devotion of this legion of students to their teacher and friend lies the greatest compliment to his teaching and mentoring.

I had the good fortune and pleasure of collaborating with Rudi in the writing of two textbooks and several articles. Our textbook *Macroeconomics*, which has sold well over a million copies worldwide, has given me as much satisfaction as anything else I have done in my professional life. And I know Rudi felt the same way.

Rudi was a vital and positive personality, who lit up any group in which he participated. He was among the most talented of men, and among the warmest, the most generous, with his time and himself, available for his students and his friends whenever they needed him. When they called or visited, Rudi would say "Tell me everything" and then give them his sympathy, his understanding, and his unsentimental advice.

We will miss Rudi deeply, including tonight, for his incisive mind, the brilliance of his insights, the exuberance of his writing, and his challenges to conventional thinking—but most of all, for his friendship and the pleasure of his company.

### I. The Globalization Debate

The debate over globalization is lively, often passionate, and has sometimes been violent. At least until recently, it has been intensifying.<sup>1</sup>

<sup>1</sup> During the 1970's the word "globalization" was never mentioned in the pages of *The New York Times*. In the 1980's the word cropped up less than once a week; in the first half of the 1990's, less than twice a week; and in the latter half of the decade, no more than three times a week. In 2000 there were 514 stories in the paper that made reference to "globalization"; there were 364 stories in 2001, and 393 references in 2002. Based on stories in *The New York Times*, the idea of being "anti-globalization" was not one that existed before about 1999. Turning from the newspaper to the internet, "globalization" brings up 1.6 million links

The debate is untidy and ill-defined, and one could react by saying that it has no place in a professional setting like this one. But we cannot afford to ignore it, for the views and attitudes expressed in it will inevitably affect public policy—and the issues are critically important for the future economic growth and well-being of all the people of the globe.<sup>2</sup>

Here is the message: Globalization, the ongoing process of greater interdependence among countries and their citizens, is complex and multifaceted. Many of the problems that the critics of globalization point to are real. Some of them relate to economics. Others relate to non-economic, but no less important, aspects of life. And while some of the problems do stem from the process of global integration, others do not.

As far as economics is concerned, the big challenge is poverty, and the surest route to sustained poverty reduction is economic growth. Growth requires good economic policies. The evidence strongly supports the conclusion that growth requires a policy framework that prominently includes an orientation toward integration into the global economy. This places obligations on three groups: those who are most responsible for the operation of the international economy, primarily the governments of the developed countries; those who determine the intellectual climate, which includes this audience but also government and nongovernment organizations and individuals; and the governments of the developing countries who bear the major responsibility for economic policy in their countries.

Let me start by discussing the historical background, the protagonists, their views, and the

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through the use of the Google search engine, and typing in "anti-globalization" brings up 80,000 links. Type in globalization and inequality, and there are almost 500,000 references; 700,000 references to globalization and environment; almost 200,000 links to globalization and labor standards; 50,000 references to globalization and multinationals; and 70,000 references to globalization and cultural diversity. A search of globalization and the IMF yields 180,000 suggestions.

<sup>2</sup> For a comprehensive review of the economic issues, see the extremely useful paper by François Bourguignon et al. (2002), which covers many of the issues in this lecture (see also International Monetary Fund, 1997; World Bank, 2002a).

issues. Economic globalization, the ongoing process of greater economic interdependence among countries, is reflected in the increasing amount of cross-border trade in goods and services, the increasing volume of international financial flows, and increasing flows of labor. As is well known to our profession, economic globalization thrived in the period before 1914, but was set back by the two World Wars and the Great Depression.<sup>3</sup> The international financial order that was established at the end of World War II sought to restore the volume of world trade, and by 1973, world trade as a percentage of world GDP was back to its 1913 level, and it has continued to grow almost every year since.<sup>4</sup>

While the founders of the Bretton Woods system saw the restoration of trade in goods and services as essential to the recovery of the global economy, they did not have the same benign view of capital flows. Nonetheless, capital flows among the industrialized countries did recover during the 1950's, and intensified in the 1960's. Rapidly they became too powerful for the pegged exchange-rate system to survive, and by 1973, as a result of the impossible trinity (of a pegged exchange rate, capital mobility, and a monetary policy directed at domestic objectives), the Bretton Woods adjustable-peg system had to give way to flexible exchange rates among the major countries.

Capital flows to developing countries grew more slowly. In the late 1970's and early 1980's they consisted mainly of bank loans; by the 1990's they took the form mainly of foreign direct investment and purchases of marketable securities. As the volume of international capital flows to and from the emerging market coun-

tries (the more developed and larger developing countries) increased, the impossible trinity once again asserted itself, and in a series of crises, country after country was forced to give up its pegged exchange rate and allow the currency to float.

By now, the gross volume of international capital flows relative to global GDP far exceeds the levels reached in the period just before 1913, though net flows of foreign direct investment have not yet attained the extraordinary levels of the decade before World War I.<sup>5</sup>

It is generally believed that, with respect to migration and labor flows, the modern system is less globalized than it was a century ago.<sup>6</sup> In 1911, nearly 15 percent of the United States population was foreign-born; today that number is probably a bit above 10 percent. Emigration rates from Europe, especially Ireland and Italy, were amazing: 14 percent of the Irish population emigrated in the 1880's, and over 10 percent of the Italian population emigrated in the first decade of the 20th century. Jeffrey Williamson (2002) attributes a significant part of the convergence of income levels in the Atlantic economy in the late 19th and early 20th centuries to mass migration.<sup>7</sup> Whether or not migration and labor flows are greater now than they

<sup>5</sup> Some suggest that capital markets remain less integrated today than in 1913 (e.g., Maurice Obstfeld and Alan Taylor, 2003).

<sup>6</sup> The note of caution is entered because it is not clear how much labor flows between developing countries (South-South labor flows) have changed. These took place on a large scale before 1913, but they are also very large today. Timothy J. Hatton and Williamson (2002 p. 25) comment "South-South migration is not new. It is just ignored by economists." What is clear is that immigration flows to and from industrialized countries are lower now than in the decade before World War I (see Williamson, 2002). For example, the annual immigration rate to the United States fell from about 11.6 per 1,000 in 1910 to 0.4 in 1940 and rose to 4 in the 1990's. The volume of remittances provides some evidence on labor-market integration. Remittances from overseas workers make labor services a major export for many poor countries. The volume of remittances increased from an annual average of \$22 billion in the 1970's (measured in 1995 dollars) to \$81 billion in the 1990's, which is more than the annual volume of aid (Claudia Busch et al., 2002).

<sup>7</sup> In his work, Jeffrey Williamson frequently uses the convergence of prices, rather than the volume of trade, as an indicator of the extent of globalization.

<sup>3</sup> Jeffrey Williamson (2002) classifies the period 1820–1914 as the first great globalization era, and the period since World War II as the second.

<sup>4</sup> Trade as a percentage of world GDP is estimated to have risen from less than 5 percent in 1800 to a peak of just over 20 percent at the start of World War I, and then collapsed to 5 percent at the end of World War II. Between 1947 and the first oil shock in 1973, world exports grew at an average annual rate of 8.8 percent per year. Between 1973 and 1990 they grew at an annual rate of 4.4 percent; the growth rate in the 1990's was 7 percent. As a result, the world's markets for goods and services are more integrated than ever before, though the pattern is different, with a rise in intra-industry trade, compared with the predominance of inter-industry trade in the earlier period of globalization.

were a century ago, we are becoming more globalized in this regard too, for migration rates have been rising—and in a potentially important way, for more migration than in the past is from less-developed to more-developed countries.<sup>8</sup>

All this is at an abstract level. In terms of people's daily lives, globalization means that the residents of one country are more likely now than they were 50 years ago to consume the products of another country, to invest in another country, to earn income from other countries, to talk on the telephone to people in other countries, to visit other countries, to know that they are being affected by economic developments in other countries, and to know about developments in other countries.

Globalization is much more than an economic phenomenon. The technological and political changes that drive the process of economic globalization have massive noneconomic consequences.<sup>9</sup> In the words of Anthony Giddens (2002 p. 10), a leading sociologist: "I would have no hesitation ... in saying that globalisation, as we are experiencing it, is in many respects not only new, but also revolutionary.... Globalisation is political, technological and cultural, as well as economic."

The noneconomic aspects are at least as important in shaping the international debate as are the economic aspects. Many of those who object to globalization resent the political and military dominance of the United States, and they resent also the influence of foreign (predominantly American) culture, as they see it at the expense of national and local cultures.

The technological elements matter in practice as well as in the debate. For instance, the events of 11 September 2001 could not have taken place before the current global era. The communications and transport systems that have accelerated the pace of globalization are also at the disposal of terrorists, money-launderers, and international criminals. On the positive side,

improvements in communications and the spread of information were critical to the collapse of the Iron Curtain. People learned what was happening in other countries and understood that they did not have to live the way they were living, and the Iron Curtain fell.

While we need to recognize the importance, and possibly the predominance, of the noneconomic elements, I shall focus on the economic debate. One set of views on economic globalization is summed up by a characteristic passage from Rudi Dornbusch (2000 p. 91):

On the verge of world deflation, Japan bankrupt and Europe moving at near-stalling speed only, the emerging markets battered and the United States beholding a glorious bubble—how can this mark the end of a great century of prosperity? And yet, this has been the best century ever, never mind the great depression, a momentary setback from communism and socialism, and two great wars. Mankind today is far and further ahead of where it has ever been and there are the seeds of innovation from biology to the Internet for better and richer lives even beyond our wildest dreams.

This century, and in particular the last three decades, have witnessed just that as the nation state has been dismantled in favor of a global economy, state enterprise and economic repression give way to free enterprise, and breathtaking innovation and greedy capitalism break down government and corporate bureaucracies. Anyone who says *impossible* finds himself interrupted by someone who just did it. The process is far from complete; innovation and free enterprise spread the mindset, the success and the acceptance of this model to the horror of status quo politicians and the sheer exuberance of all those who are willing to embrace a can-do attitude. If this century taught anything it is surely this: even daunting setbacks like depression and war are only momentary tragedies—buying opportunities, if you like—in a relentless advance of the standard of living and the scope for enjoying better lives. One of the great economists of this century, Joseph Schumpeter—Austrian finance minister of the 1920s

<sup>8</sup> The fact that migration often has a brain-drain aspect raises important issues.

<sup>9</sup> The rapid increases in global integration in the second half of the 19th century and early 20th century were driven by the outbreak of peace in Europe and the invention of the telegraph, the steamship, and the railroad.

and Harvard professor at the end—wrote of creative destruction as the dramatic mechanism of economic progress. That process is at work.

A broad range of critics is arrayed on the other side. Among them are academics, opinion leaders, individuals and groups who see their interests being affected by globalization, politicians, NGO's, and demonstrators—and these categories are not mutually exclusive.<sup>10</sup> To listen to the debate in the terms each side paints the other, one might think that it is a discussion between Dr. Pangloss, who believes that all is for the best in the best of all possible worlds, and those who believe that the world is going to hell in a handbasket. That is doubly misleading. In the first place, many of those who regard themselves as pro-globalization, myself among them, know that there is far too much misery in the world, that there are many wrongs to be righted in the global economy, and that it could be made to operate much better. And on the other side, many (but not all) of the critics are not against globalization. Rather, from NGO's demonstrating for further debt relief and campaigning for greater access of developing-country exports to industrialized-country markets, to academic critics questioning current policy views, many are seeking a better and fairer globalization.

I will discuss five of the key economic issues in the debate:<sup>11</sup>

- (i) whether poverty and inequality are increasing or decreasing;
- (ii) whether integration into the global economy is good for growth;
- (iii) whether the international financial system is too crisis prone, and capital flows need to be banned or regulated;
- (iv) the unfairness of the global trading system, and the inadequacy of aid flows;
- (v) the role of the IMF.

For want of time, but also for lack of comparative advantage, I will not cover a host of

other economic issues that feature in the debate over globalization and its consequences, among them: whether globalization results in unfair labor practices in developing countries—an argument which is not compelling; whether globalization damages the environment; whether multinational corporations have become too powerful to the detriment of developing-country citizens and governments; whether globalization gives rise to tax competition that undermines the capacity of governments to raise revenues and thus to provide necessary services to their citizens; whether intellectual-property protection is damaging the health of developing-country citizens; and the roles of the World Bank and the World Trade Organization. These are important issues, some of them critical, and some do not have simple answers. But these problems are being seriously analyzed by economists, for instance by Bourguignon et al. (2002) for the European Commission, by the World Bank (2002a), and others.<sup>12</sup>

One question before turning to the evidence: Almost everyone recognizes that the world could be a better place, and that there is much work to be done to improve it. Why then is so much of the debate about whether the world is getting better or worse, rather than about what can be done to make it a better place? *It is because the debate is ultimately about policies.* The implicit premise is that if the world is going to hell, then the policies that have been followed for the past 50 years are likely to be wrong. And if the world has been getting better, then the policies are more likely to be right.<sup>13</sup> It is a separate question whether it is globalization that is responsible for what has happened.

The policies in dispute are generally those that have been recommended by the international financial institutions and most industrialized-country governments.<sup>14</sup> At the broadest level,

<sup>12</sup> For references to the literature, see Bourguignon et al. (2002); on the trade-related issues, see also Jagdish Bhagwati (2000).

<sup>13</sup> While persuasive, the implicit proposition is not logically compelling, for policies could be wrong even if the world is improving, and right even if the world is deteriorating.

<sup>14</sup> In that regard, the present discussion is merely the latest manifestation of a long-running economic policy

<sup>10</sup> For a discussion of the anti-globalization groups and their concerns, see Kimberly Ann Elliott et al. (2003).

<sup>11</sup> See the discussion of the 12 charges against globalization in the final chapter of Bourguignon et al. (2002).



the policy consensus consists of four elements: policies to ensure macroeconomic stability; market-oriented microeconomic policies; integration into the global economy, particularly on the trade side; and a positive role for government in establishing, monitoring, and developing the institutional framework of the economy, providing public goods including especially social expenditures, and conducting stabilization policies.

Beyond these broad headings, detailed policy recommendations have been spelled out in many World Bank and IMF publications, for instance the *World Development Reports* of the World Bank.<sup>15</sup> One formulation that has received much attention and a large share of calumny is the so-called Washington consensus set out by John Williamson (1990).<sup>16</sup> The ten elements of the 1990 consensus were (i) fiscal discipline, (ii) public-expenditure priorities in education and health, (iii) tax reform (the tax base should be broad, and marginal tax rates should be moderate), (iv) positive but moderate market-determined interest rates, (v) a competitive exchange rate as the “first essential element of an ‘outward-oriented’ economic policy” (p. 14), (vi) import liberalization, (vii) openness to foreign direct investment (but “liberalization of foreign financial flows is not regarded as a high priority” [p. 15]), (viii) privatization (based on “the belief that private industry is managed more efficiently than state enterprises” [p. 16]), (ix) deregulation, and (x) protection of property rights.

The Washington consensus is a brand name that has been so abused as probably to have outlived its usefulness. While no short description of the economic policy choices that face a country and of the principles that it should follow can be adequate to the complexities of the real-

world situation confronting policymakers, I still regard these ten elements as a useful shorthand description of a major part of a desirable basic policy orientation.<sup>17</sup> And for that reason I shall at least for a while continue to use the term “Washington consensus.”

## II. The Evidence on Poverty and Global Inequality

### A. Poverty

For some time it was accepted that the proportion of people living in poverty in the world has been declining, but their absolute number has been increasing. This refers to the World Bank’s measure of absolute poverty, defined as living on a real income of less than one dollar a day.<sup>18</sup> There is no consistent fully reliable set of data reflecting longer-term developments in poverty.<sup>19</sup> A useful estimate of post-World War II developments is shown in Figure 1: the global poverty rate is estimated to have declined impressively from about 55 percent in 1950 to 23.7 percent in 1992.<sup>20</sup> It has continued falling since.

The data most often used in discussing recent poverty developments come from the World Bank and are based on national estimates of poverty rates. These estimates are likely to be subject to significant error, as the recent debate over the Indian poverty data illustrates. Indian growth in the 1990’s averaged nearly 6 percent, more than 3 percent per capita. Aggregate consumption in the national income accounts rose by 3.2 percent per capita. But household survey data, on which India’s poverty estimates are

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debate that has at times pitted protectionists against free-traders and those who believe in a greater role for the state against those who believe more in markets.

<sup>15</sup> See David Lindauer and Lant Pritchett (2002) for an account of changing views of development policy during the post-World War II period.

<sup>16</sup> These were not necessarily John Williamson’s views, but rather his attempt to capture the consensus of the time. In the article, he expands on the range of views (including his own, which generally include several qualifications) under each heading.

<sup>17</sup> I was one of the discussants of the Williamson (1990) paper at the time (my comments are on pp. 25–28) and mentioned among the missing elements the responsibility of the government to create an enabling environment for economic activity, the need for directed anti-poverty policies, and environmental concerns.

<sup>18</sup> Strictly speaking, the \$1 per day figure corresponds to a Penn World Tables Purchasing Power Parity income of about \$1.08 in 1993 prices (Shaohua Chen and Martin Ravallion, 2001).

<sup>19</sup> I am particularly grateful to Angus Deaton for guiding me through the debate on the poverty data. He bears no responsibility for the views set out in this section.

<sup>20</sup> These data are from Bourguignon and Christian Morrisson (2002).

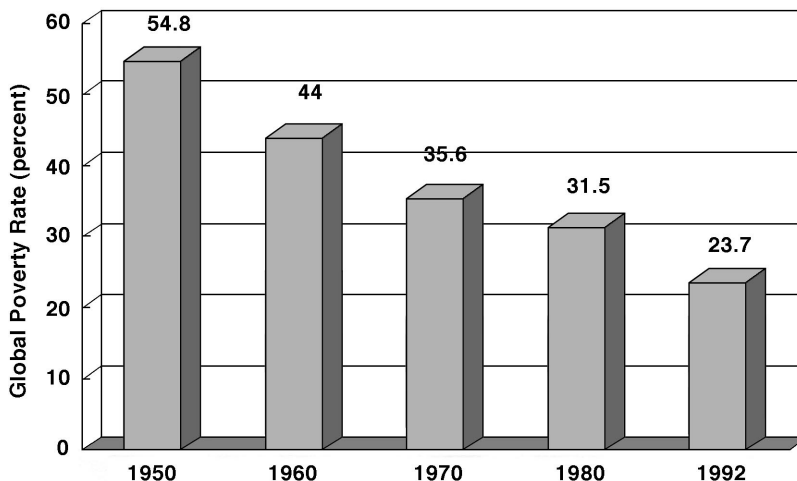


FIGURE 1. GLOBAL POVERTY RATES: PERCENTAGE OF PEOPLE LIVING ON LESS THAN \$1 PER DAY

Source: Bourguignon and Morrisson (2002).

based, showed very little increase in per capita consumption.<sup>21</sup>

Based on the sample surveys, poverty declined relatively little in India in the 1990's. Based on the national income accounts, it should have declined significantly. One way of combining the data, chosen by Surjit Bhalla (2002), is to assume that the distribution of consumption in the sample surveys is correct, but to adjust the mean increase in consumption in the sample surveys to equal that in the national income accounts. This produces spectacular declines in poverty in India during the 1990's.

The official data also show significant, but smaller, declines in the Indian poverty rate, from about 40 percent in 1987–1988 to 26 percent in 1999–2000. In checking these data, Deaton (2002a) reports, “Much to my surprise, most of the officially claimed reduction in poverty appears to be real.”<sup>22</sup>

<sup>21</sup> Angus Deaton (2002a) provides a brief description of the problem.

<sup>22</sup> Deaton, whose work is regarded as authoritative, estimates the poverty rate for 2000 to be 28 percent; he finds that the poverty rate in India declined fairly steadily over the past 20–30 years, with no evidence of a pickup following the reforms in 1991. But he notes (Deaton, 2002a) that

Applying the Bhalla procedure to all countries also produces rapid declines in global poverty.<sup>23</sup> More cautiously, recent World Bank data show the global poverty rate declining sharply from 29.6 percent in 1990 to 23.2 percent in 1999 (Table 1).<sup>24</sup> According to these estimates (and they are only estimates), the absolute number of the poor declined by 123 million people, or 10 percent, during this period. The number of poor in China alone fell by 150 million. Table 1 shows that the major decline in the global poverty rate is accounted for by Asia, with the absolute number of poor in sub-Saharan Africa

neither is there any evidence that the pro-market reforms led to increases in poverty or slowed poverty reduction.

<sup>23</sup> Bhalla's (2002) estimates are that poverty was 30 percent in 1987, and only 13 percent in 2000. This would imply that the last decade of the last century was the most successful in all of history in reducing poverty. Xavier Sala-i-Martin (2002b) shows even larger declines in global poverty counts over the period 1970–1998, using a similar methodology. He estimates the \$1 per day poverty rate to be only 5 percent in 1998.

<sup>24</sup> Surprisingly, the heading on a table very similar to Table 1 (table 1.2, p. 18) in the United Nations Development Program's (2002) *Human Development Report* is: “Worldwide, the number of people living on less than \$1 a day barely changed in the 1990s.” The table shows that even the absolute number of those living on less than \$1 a day declined by 10 percent in the 1990's.

TABLE 1—REGIONAL BREAKDOWN OF POVERTY IN DEVELOPING COUNTRIES

Region	Number of people living on less than \$1 per day (millions)			\$1 per day headcount index (percent)		
	1987	1990	1999	1987	1990	1999
East Asia and Pacific, excluding China	418	486	279	26.6	30.5	15.6
Europe and Central Asia	1	6	24	0.2	1.4	5.1
Latin American and the Caribbean	64	48	57	15.3	11.0	11.1
Middle East and North Africa	9	5	6	4.3	2.1	2.2
South Asia	474	506	488	44.9	45.0	36.6
Sub-Saharan Africa	217	241	315	46.6	47.4	49.0
Total:	1,183	1,292	1,169	28.3	29.6	23.2
Excluding China:	880	917	945	28.5	28.5	25.0

Source: World Bank staff estimates (*Global Economic Prospects 2003*).

(and also in the transition economies) rising significantly.

Between them, China and India account for 38 percent of the world's population. In 1990 they accounted for 60 percent of the world's poor. It is therefore hardly surprising that the global poverty rate fell sharply in a decade in which China grew at more than 9 percent and India at 6 percent. It may be argued that what happened in China and India is atypical. That is true if the unit is the country, but not if the unit is the individual.<sup>25</sup> Further, there can be little doubt that, in both India and China, the growth policy during the period was pro-globalization, pro-entry into the global economy. Of course, not every detail of policy in either country followed the Washington consensus, but both countries grew faster after opening up.<sup>26</sup>

Beyond the data on per capita income, most social indicators have also shown considerable improvement in the postwar period and more recently. As Figure 2 (taken from the United Nations Development Program's [2002] *Human Development Report*) shows, adult literacy has

risen in all regions in the last 25 years, and infant mortality has declined significantly. Life expectancy has risen in most regions. However, under the impact of the HIV/AIDS pandemic, it has begun to decline in sub-Saharan Africa, with particularly large and tragic impact in Botswana, Zimbabwe, South Africa, and Kenya.<sup>27</sup>

The *Human Development Report* presents a Human Development Index (HDI), which is based on three equally weighted factors, life expectancy, education, and (the logarithm of) a purchasing-power-parity estimate of per capita GDP.<sup>28</sup> Figure 3 shows changes in the HDI over the past 20 years. Note in particular that the HDI is inherently an index of *relative* performance, so that the improvements in all regions represent a convergence of this more general measure of economic and social progress across regions.

In addition, as the 2002 *Human Development Report* shows, democracy has been spreading, including in the developing world. By one clas-

<sup>25</sup> The sharp differences in poverty rates among Indian states and among Chinese provinces should also contain policy-relevant information.

<sup>26</sup> However, Deaton (2002b) finds no acceleration in the rate of poverty reduction following India's policy reforms in 1991.

<sup>27</sup> Life expectancy is estimated by applying *current* age-specific mortality rates; it thus is not the life expectancy of an individual born today, for which it would be necessary to forecast mortality.

<sup>28</sup> All measures are taken relative to the highest level attained within the sample, so the index is bounded above by 1.



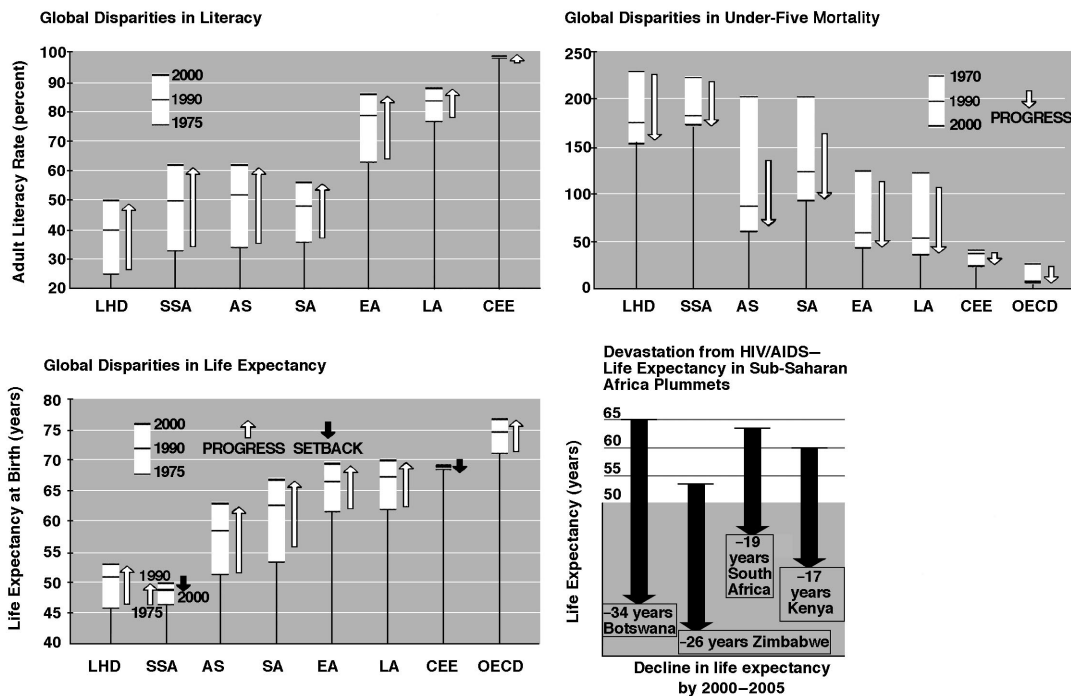


FIGURE 2. ALTERNATIVE INDICATORS OF HUMAN DEVELOPMENT

Notes: Regions are abbreviated as follows: LHD, low human development; SSA, sub-Saharan Africa; AS, Arab states; SA, south Asia; EA, east Asia and the Pacific; LA, Latin America and the Caribbean; CEE, central and eastern Europe and CIS; OECD, high-income OECD.

Source: United Nations Development Program’s (2002) *Human Development Report*.

sification, the number of authoritarian regimes declined from 67 to 26 between 1985 and 2000 (hardly surprising given the transition in the former Soviet bloc and the changes in Latin America) while the number of nations categorized as “most democratic” rose from 44 to 82 (United Nations Development Program, 2002 [fig. 1.1]).

Thus there is considerable evidence that on average conditions have been improving in the developing countries. That is to say, the world is not going to hell in a handbasket. But that is emphatically not to say that everyone in the developing countries is doing better. In particular, conditions in most of sub-Saharan Africa, where per capita growth has been negative in nearly half the countries in the last quarter century, have been deteriorating, and Latin America has not done well in the last decade.

The discussion of trends in global poverty is a significant part of the globalization debate. But it does not directly address the globalization issue, of whether whatever has been happening is caused by increasing integration into the global economy. That question will be addressed when I discuss the impact of openness on growth.

B. Inequality

While a global Rawlsian perspective would lead to a focus on poverty reduction, we need to focus also on inequality, not only because for many great inequality is undesirable per se, but also because growing inequality may have powerful political consequences. For instance, in the first era of globalization, changes in the income distribution that affected real wages and the returns to land and capital led to pressure to

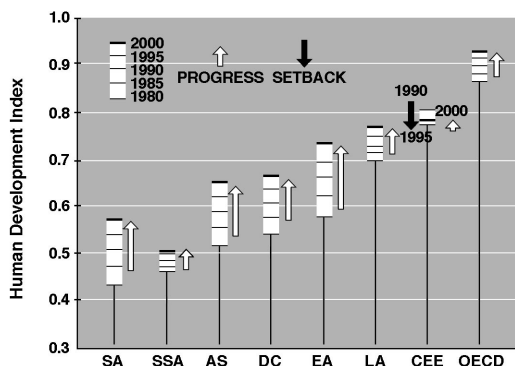


FIGURE 3. RECENT TRENDS IN THE HUMAN DEVELOPMENT INDEX (HDI), SHOWING GLOBAL DISPARITIES

Notes: Regions are abbreviated as follows: SA, South Asia; SSA, sub-Saharan Africa; AS, Arab States; DC, all developing countries; EA, east Asia and the Pacific; LA, Latin America and the Caribbean; CEE, central and eastern Europe and CIS; OECD, high-income OECD.

Source: United Nations Development Program's *Human Development Report* office calculations based on indicator table 2.

limit economic integration (Jeffrey Williamson, 2002). That could happen again, as globalization creates losers as well as winners in the short run.<sup>29</sup>

Inequality among national average incomes appears to have been increasing for at least 400 years, since before the rapid increases in economic integration that took place in the 19th century (Jeffrey Williamson, 2002). However, this long-term rise in inequality among national average incomes seems to have slowed during the past 20 years (see Bourguignon and Morrisson, 2002; Sala-i-Martin, 2002a, b).

The convergence debate in macroeconomics was based on purchasing-power-parity estimates of national average incomes. As is well known, and as Figure 4 illustrates, the raw data on country average incomes show divergence, not convergence. The early results, for instance those of Robert J. Barro (1997), supported *conditional* convergence. Provided the conditioning variables do not change in an offsetting direction, conditional convergence implies that the

<sup>29</sup> See Branko Milanovic (2002b) for a forceful statement of the view that current trends are likely to produce a backlash unless globalization as we know it is tamed.

inequality among country average incomes would eventually decline—but that could take a very long time. The weight of the evidence appears now to have moved away from the initial conclusion of conditional convergence toward the twin-peaks view, that there is a convergence club among the high-income OECD countries, while lower-income countries are converging to a lower income level (Danny T. Quah, 1996).

Developments in inequality *within* countries may be politically more important than changes in inequality among countries. There was a rise in inequality in the United States and the United Kingdom from the start of the 1980's until well into the last decade. Inequality during that period did not increase markedly in continental Europe, probably due to labor-market regulations, social welfare programs, and tax systems.<sup>30</sup> Reviewing the literature, Lawrence F. Katz and David H. Autor (1999) concluded that trade explains at most 20 percent of the rise in inequality in the United States and that skill-biased technological change explains 80 percent of the rise.<sup>31</sup> There are also instances of increasing inequality within some poor countries, including China and India, even though incomes have increased at both the top and the bottom of the scale. In the transition economies of the former Soviet bloc, inequality increased sharply in the 1990's.

Beyond the inequalities among national average incomes, and within countries, stands the concept of the distribution of global income among all the world's people, of which there are now several estimates (e.g., Bhalla, 2002; Bourguignon and Morrisson, 2002; Milanovic, 2002a; Sala-i-Martin, 2002). These are all based on data on the distribution of income within nations, and some method (typically using purchasing power estimates) for comparing income levels across countries. Figure 5 shows why such an estimate might find inequality declining

<sup>30</sup> They may well instead have produced higher unemployment.

<sup>31</sup> Kenneth Scheve and Matthew Slaughter (2001) emphasize what they call the "skills-preferences cleavage" on globalization among the American public, in which views on globalization are significantly affected by the skill level of poll respondents.

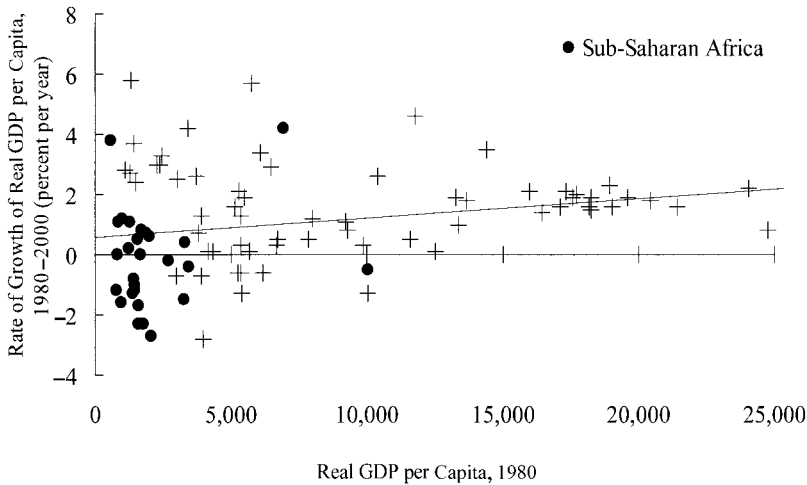


FIGURE 4. AVERAGE ANNUAL GROWTH (1980–2000) ON INITIAL LEVEL OF REAL GDP PER CAPITA

Note: The data are values for real GDP in U.S. dollars per equivalent adult.

Source: Penn World Tables, version 6.1 (available online: <http://pwt.econ.upenn.edu/>).

among nations: it is the graphic representation of a population-weighted convergence diagram, in which the dominance of China and India drives the relationship. Bourguignon and Morrisson (2002) conclude that the inequality of global income worsened from the start of the 19th century until the end of World War II “and after that seems to have stabilized or to have grown more slowly.”<sup>32</sup>

Where does that leave us on both poverty and the global distribution of income? Poverty rates have been declining, especially in Asia. So very likely has the absolute number of those living at below one dollar a day. Increasingly, global poverty is being concentrated in Africa. At the same time, poverty rates have not declined much in Latin America in recent decades. Taking account of other social indicators, as re-

flected in the HDI, presents a more encouraging picture of the changing fortunes of the poorest, but the HIV-AIDS epidemic is taking a sad toll on longevity in Africa.

Income-distribution developments are more mixed. There has been a growing divergence among national average incomes. Inequality has risen within many countries; but it is likely that inequality among the world’s citizens declined during the last decades of the 20th century. However, we should not take too much comfort from that, for as Sala-i-Martin (2002a) points out, “Unless Africa starts growing in the near future, ... income inequalities will start rising again.”

### III. The Policy Issues

#### A. Trade and Growth

Trade policy has long been central to economic policy choices. In the early post-World War II period, the theory of import-substituting industrialization (ISI) dominated among developing countries, and its implementation for some time seemed to produce positive results. Then, as time went by, it was observed both that countries that had pursued export promotion

<sup>32</sup> However, Milanovic (2002a) finds that global income inequality increased between 1988 and 1993, in part because of growing gaps between rural and urban incomes in China. By contrast, Bhalla (2002) shows world inequality in 2002 at its lowest level in the post-World War II period, a result of the much greater reductions in global poverty in the 1990’s that his methodology produces. Similarly, Sala-i-Martin (2002a) finds massive decreases in global inequality at the individual level between 1980 and 1998.

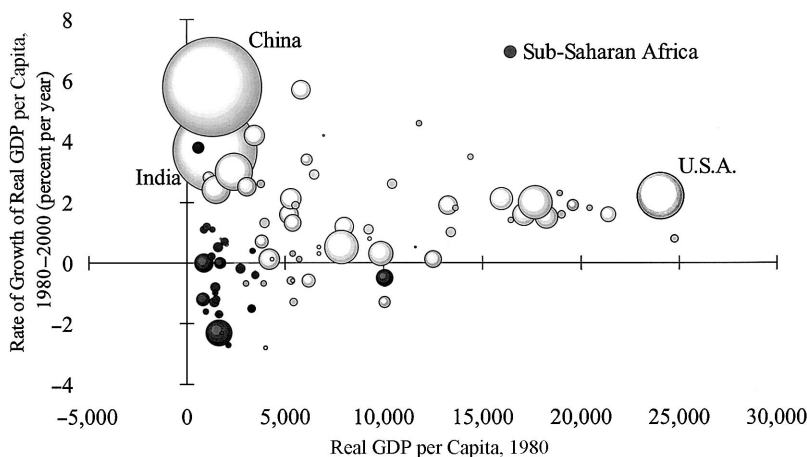


FIGURE 5. AVERAGE ANNUAL GROWTH (1980–2000) ON INITIAL LEVEL OF REAL GDP PER CAPITA (AS IN FIG. 4, BUT WITH AREA PROPORTIONAL TO POPULATION IN 1980)

Note: The data are values for real GDP in U.S. dollars per equivalent adult.

Source: Penn World Tables, version 6.1 (available online: <http://pwt.econ.upenn.edu/>).

strategies were more successful than those that had focused on keeping imports out and that the returns to ISI seemed to be diminishing.

Early case studies of trade liberalization were conducted in the 1970's and 1980's under the auspices of the OECD, the National Bureau of Economic Research (NBER), and later the World Bank.<sup>33</sup> These by and large supported the case for export promotion policies, that is, for integration into the global economy. Subsequently a host of cross-sectional regression studies were undertaken,<sup>34</sup> most of them showing that greater openness is associated either with higher levels of income or more rapid growth.<sup>35</sup> The study by Jeffrey Sachs and Andrew Warner

(1995) which concludes that, *ceteris paribus*, open countries grow 2 percent per annum more rapidly than closed countries, has received particular attention. A closely related literature examines the mechanisms through which openness contributes to growth, particularly through its impact on productivity, where the availability of imported inputs plays a role.<sup>36</sup>

The regression studies have been comprehensively reexamined and criticized by Francisco Rodriguez and Dani Rodrik (2001), who argue that the results are not robust, the measures of openness used in the studies neither clearly exogenous nor consistent across studies, and the econometrics flawed.<sup>37</sup> Nonetheless, the case studies that show trade liberalization as an essential element in policy reforms that led to growth, the bulk of the empirical evidence, and the fact that the most spectacular growth stories all involve rapid increases in both exports and imports (frequently after specific policy deci-

<sup>33</sup> The NBER studies are summarized in Bhagwati (1978) and Anne Krueger (1978); the World Bank studies are summarized in Michael Michaely et al. (1991).

<sup>34</sup> T. N. Srinivasan and Bhagwati (1999) criticize the regression approach in arguing for the superiority of the case-study method. I have used both methods on different occasions and regard each as having important weaknesses (see also Krueger, 1983).

<sup>35</sup> Examples include David Dollar (1992), Dan Ben-David (1993), Jeffrey Sachs and Andrew Warner (1995), Sebastian Edwards (1998), Jeffrey Frankel and David Romer (1999), and Dollar and Aart Kraay (2001a, b). Robert E. Hall and Charles Jones (1999) include both openness (the Sachs-Warner index) and a measure of good governance, which is highly correlated with the openness indicator.

<sup>36</sup> The literature on openness and growth is well summarized by Bourguignon et al. (2002 pp. 37–39) and by Andrew Berg and Krueger (2003).

<sup>37</sup> Warner's (2001) draft response to the Rodriguez-Rodrik critique strongly disputes several of these criticisms, including the suggestion that the black-market premium is not a useful indicator of trade distortions, and reaffirms the Sachs-Warner conclusions.

sions have been made to open up) should persuade us that openness to the global economy is a necessary, though not sufficient, condition for sustained growth.<sup>38</sup> To quote Dani Rodrik (2001 p. 23), “No country has developed successfully by turning its back on international trade and long-term capital flows.”

To say that is not to say that immediate full trade liberalization is necessarily the best policy for a country, nor that opening to trade is sufficient for growth, nor that the accompanying policy framework is irrelevant.<sup>39</sup> Indeed the accompanying framework is essential. It is to say, however, that countries that want to grow should as a key part of their policy framework orient themselves toward integration into the global trading system, to take advantage of the availability both of much larger global than domestic markets, and of more sophisticated capital-, intermediate-, and consumer-good imports.<sup>40</sup>

### B. *Growth, Poverty, and Inequality*

Here I can be brief. Logic dictates that there is no way of lifting the populations of poor countries out of poverty (say, on the scale that has been achieved in East Asia) without sustained growth. Globally, the decline in poverty

<sup>38</sup> Rodrik (2001 p. 23) does not disagree with this conclusion, emphasizing rather the speed of adjustment and the need for accompanying policies: “The trick in the successful cases has been to combine the opportunities offered by world markets with a domestic investment and institution-building strategy to stimulate the animal spirits of domestic entrepreneurs. Almost all of the outstanding cases—East Asia, China, India since the early 1980s—involve partial and gradual opening up to imports and foreign investment.”

<sup>39</sup> Berg and Krueger (2003 p. 39) state, “Openness has important positive spillovers on other aspects of reform, so the correlation of trade with other pro-reform policies speaks to the advantages of making openness a primary part of the reform package.” This relates to an emerging literature (e.g., Dollar and Kraay, 2002; William Easterly and Ross Levine, 2002) that argues either that the growth effects of openness and the institutional structure of the economy are difficult to distinguish, or that institutions are more important. I find the Berg-Krueger argument on this point persuasive.

<sup>40</sup> Nancy Birdsall (2002) argues that openness does not work well for the poorest countries, because of their greater dependence on primary exports and because of their greater vulnerability to external shocks. It is nonetheless difficult to see how a small economy could hope to reach a high level of income without integrating into the global economy.

has been fastest where economic growth has been fastest (in developing Asia) and slowest where growth performance has been worst (in Africa).

Nor, despite the early results of Simon Kuznets, does there appear to be any inevitable association between growth and inequality; rather, it depends on the details of the policies, including distributional policies, that accompany the growth strategy.<sup>41</sup> In two related studies, Dollar and Kraay (2001a, b) conclude, based on data from 92 countries, that on average the income of the lowest fifth of the income distribution rises one-for-one with aggregate income, and that this same relationship holds for growth that is induced by trade liberalization.

To say that, on average, growth or opening to trade does not adversely affect the incomes of the poor is not to say that the impact of policy changes on income distribution should be ignored when any particular policy change is being considered. The opening of trade is designed to affect domestic relative prices and most likely will affect the distribution of income in each case.<sup>42</sup> If these effects are judged to be adverse, transitional compensatory measures and gradual liberalization may help mitigate them (see Scheve and Slaughter, 2001 pp. 94–96). It is also the case that a small economy tends to be more vulnerable to fluctuations in the terms of trade when it is open than when it is closed, and that the poor may be the most vulnerable in this regard.<sup>43</sup>

### C. *Capital-Account Liberalization*

There is far more controversy about capital-account liberalization as part of a growth strategy than there is about current-account liberalization. That is not surprising, for as the

<sup>41</sup> Barro (1999) states that the Kuznets curve does emerge as a clear empirical regularity but does not explain most of the variations of inequality across countries or over time.

<sup>42</sup> Mattias Lundberg and Lyn Squire (1999) find that growth is more sensitive than inequality to policy interventions.

<sup>43</sup> There is no general prescription for what these policies should be; they need to be designed taking the circumstances of the country into account; for instance, in the Indonesian crisis of 1997–1998, subsidizing the price of rice was a key pro-poor policy.



Asian crisis drove home, a country with an open capital account is more vulnerable to external shocks than one that is closed to external capital flows.

In considering capital-account liberalization, I assume that countries will and should at some stage in the course of their development want to liberalize the capital account and integrate into global capital markets. This view is based in part on the fact that the most advanced economies all have open capital accounts; it is also based on the conclusion that the potential benefits of *well-phased and well-sequenced* integration into the global capital markets (and this includes the benefits obtained by allowing foreign competition in the financial sector) outweigh the costs.<sup>44,45</sup>

With regard to empirical evidence on the benefits of capital-account liberalization, I believe we are roughly now where we were in the 1980's on current-account liberalization—that some evidence is coming in, but that it is at this stage weak and disputed.<sup>46</sup> The direction of causation is particularly problem-

atic in this case, for as Hali Edison et al. (2002b) note, successful economies are generally open economies.

The relationship between capital-account liberalization and growth is likely to be inherently weaker than that between current account liberalization and growth, since it is more dependent on the sequencing of reforms, and the presence of preconditions (e.g., a strong macroeconomic framework) than is the current-account liberalization relationship. An interesting finding in this regard is that of Carlos Arteta et al. (2001), who conclude that capital-account openness has a positive impact on growth contingent on the absence of a large black-market premium—which is a good indicator of the absence of macroeconomic imbalances.

At present most developing countries maintain capital controls. Experience suggests they should only be removed gradually, at a time when the exchange rate is not under pressure,<sup>47</sup> and as the necessary infrastructure (in the form of strong domestic financial institutions, a sound macroeconomic framework, a market-based monetary policy, the underpinnings of an effective foreign-exchange market, and the information base necessary for the markets to operate efficiently) is put in place.<sup>48</sup> For most countries, it would be desirable to begin allowing some flexibility of exchange rates as the controls are eased, unless the country intends to move to a hard peg—and after Argentina, that does not look advisable, unless there is a clearly defined terminal condition.<sup>49</sup> Prudential controls

<sup>44</sup> The argument is developed at greater length in Fischer (1998). The point has been much disputed, including by Bhagwati (1998).

<sup>45</sup> It is also based on the views that in practice capital controls are often discriminatory, a standing invitation to corruption, and grow progressively less effective over time.

<sup>46</sup> Rodrik (1998) presents a critical view of capital-account liberalization. A set of papers presented at a May 2002 World Bank conference “Financial Globalization: A Blessing or a Curse?” (available online: [http://www.worldbank.org/research/conferences/financial\\_globalization.htm](http://www.worldbank.org/research/conferences/financial_globalization.htm)) on balance pointed to small positive impacts of financial liberalization on growth (see e.g., Geert Bekaert et al. (2002), Anusha Chari and Peter B. Henry (2002), Arturo Galindo et al. (2002), Pierre Gourinchas and Olivier Jeanne (2002), and Carmen Reinhart and Ioannis Tokatlidis (2002)). Hali Edison et al. (2002a) review the literature on the relationship between growth and capital-account liberalization. They find that capital-account liberalization spurs growth significantly in a middle-income range of countries, but not for rich or poor countries. However, in a study of 57 countries, using a wide array of measures of international financial integration and an assortment of statistical methods, Edison et al. (2002b) are unable to establish a relationship between greater international financial integration and faster economic growth. They do identify indirect effects, by finding a significant impact from capital-account liberalization on investment and financial development; these two channels are estimated to increase growth by 0.5 percent per year or more.

<sup>47</sup> The removal of controls on outflows sometimes results in a capital *inflow*, a result of foreigners or domestic residents bringing capital into the country in light of the greater assurance it can be removed when desired.

<sup>48</sup> Some countries have attempted to impose controls on outflows once a foreign-exchange crisis is already under way. This use of controls has generally been ineffective (see Akira Ariyoshi et al., 2000 pp. 18–29; Edwards, 1999 pp. 68–71). It has also to be considered that the imposition of controls for this purpose in a crisis is likely to have a longer-term effect on the country's access to international capital. For the record, I should note here that there is very little information about such use of controls in the Malaysian case of 1998, for the controls were imposed when exchange rates in the region were at their most depreciated, and as capital flows in all the crisis countries were reversing.

<sup>49</sup> For instance, that the country plans to join the European Monetary Union and give up its currency.

that have a similar effect to some capital controls, for instance, limits on the open foreign-exchange positions that domestic institutions can take, should also be put in place as direct controls are removed.<sup>50</sup>

Any country using capital controls builds up an information system on capital flows. It may be useful to maintain an information base for some time even after the removal of controls, as in the Brazilian case, for such information can be useful in managing a crisis.

Several countries, among them Singapore, the three Asian crisis countries, and Malaysia have taken steps to limit the offshore use of their currencies. In principle this makes it possible to break the link between onshore and offshore interest rates, particularly by restricting the convertibility of the currency for non-residents—who need access to the domestic banking system to complete their transactions (see Shogo Ishii et al., 2001).<sup>51</sup> Ishii et al. (2001) conclude that such restrictions have been more successful the more comprehensive they have been, and that they could provide the authorities with a breathing space in which to implement policy changes.<sup>52</sup> But as with other capital controls, their effectiveness tends to erode over time. Further, the longer the measures are implemented, and the stronger they are, the higher the associated costs in terms of the efficiency of the financial system are likely to be.

Excessive indebtedness of domestic financial and nonfinancial institutions arises not from capital outflows, but from inflows, especially short-term inflows. Market-based capital-inflow controls, Chilean style, could be helpful for a country seeking to avoid the difficulties posed for domestic policy by capital inflows. This typically occurs when a

country is trying to reduce inflation using an exchange-rate anchor and, for anti-inflationary purposes, needs interest rates higher than those implied by the sum of the foreign interest rate and the expected rate of currency depreciation. A tax on capital inflows can help maintain a wedge between the two interest rates. In addition, by taxing short-term capital inflows more than longer-term inflows, capital-inflow controls can also in principle influence the composition of inflows.

Evidence from the Chilean experience implies that controls were for some time successful in allowing some monetary-policy independence, and also in shifting the composition of capital inflows toward the long end. Empirical evidence presented by José De Gregorio et al. (2000) suggests that the Chilean controls lost their effectiveness after 1998. They have recently been removed.

Thus, controls can be used to help limit capital outflows and maintain a pegged exchange rate, given domestic policies consistent with maintenance of the exchange rate. However, such controls tend to lose their effectiveness and efficiency over time. Capital-inflow controls may for a time be useful in enabling a country to run an independent monetary policy when the exchange rate is softly pegged and may influence the composition of capital inflows, but their long-term effectiveness to those ends is doubtful.

#### *D. Instability in the Global Financial System*

The series of emerging-market financial crises from Mexico in 1994 to Asia to Russia, Brazil, Turkey, Argentina, and Brazil again, has been at the center of the globalization debate. The crises hit some countries that had at times been described as model reformers, and others (in Asia) that had been growing very fast. The crises took a heavy toll on almost all of the crisis countries, as well as on other countries affected by the contagion.<sup>53</sup> Figure 6 shows the behavior of output in the crises.

<sup>50</sup> Morris Goldstein (2002) recommends a “managed floating plus” regime, where the plus consists of measures to discourage currency mismatching by domestic institutions.

<sup>51</sup> This paper describes three different mechanisms that are used to limit offshore currency trading.

<sup>52</sup> Singapore has been gradually dismantling these controls. Jaewoo Lee (2001) concludes that the Singapore controls were successful in large part because the underlying macroeconomic imbalances were very small and therefore did not provide significant incentives to circumvent the controls.

<sup>53</sup> In this section I draw heavily on Fischer (2001, 2002).

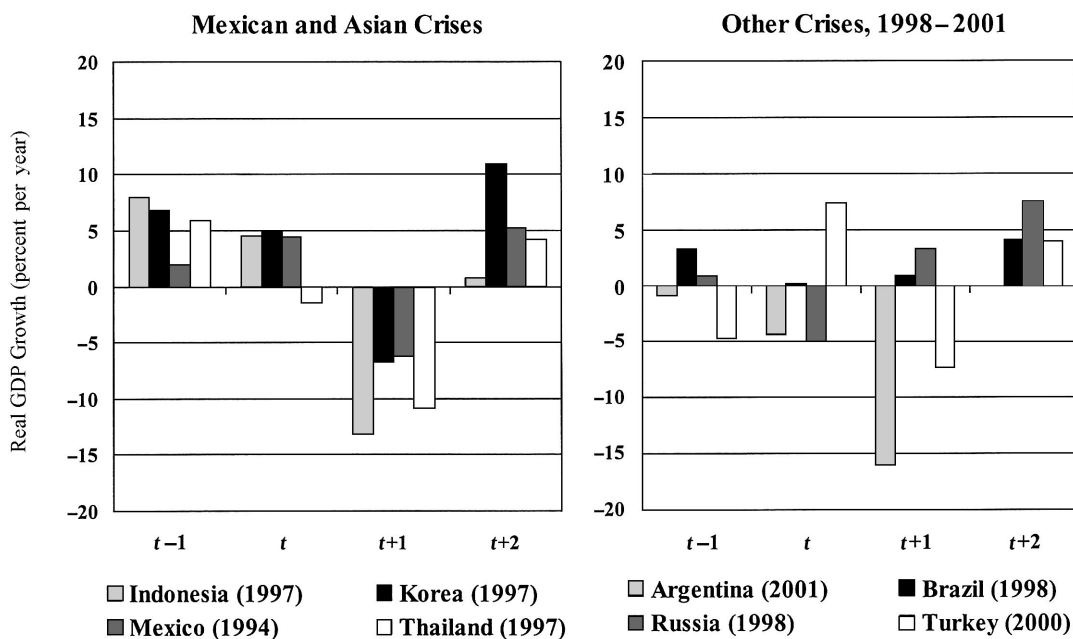


FIGURE 6. REAL GDP GROWTH

Source: International Monetary Fund (*World Economic Outlook*).

The proximate cause of most of the crises was the reversal of large-scale short-term capital flows. In every case except Brazil in 2001–2002, the crisis affected a country with a more or less formally pegged exchange rate, which gave way, usually at the beginning of the crisis. In every case except in Brazil, the crisis hit a country with a weak financial system—though the Russian financial system was very small at the time of the crisis, and the Argentinian banking system had been strong a year before the crisis but was severely weakened by measures imposed on it in attempts to preserve the currency peg.

Capital-flow volatility during the crises was massive. For the extreme cases, between 1996 and 1998, private capital inflows to Indonesia declined by 16.5 percent of GDP, while the turnaround for Turkey between 2000 and 2001 was 13.6 percent of GDP. Among the crisis countries shown in Figure 6, the smallest reversal in private capital flows was in Brazil, where the decline was by 3.1 percent of GDP between 2001 and 2002. This helps explain why Brazil is

the only country that kept growing through its external crises.

Although hedge funds received a large share of the blame for the reversals, and were probably predominant in determining the timing of some of the crises,<sup>54</sup> the reversals were more general and not confined to short-term funding. Neither were they confined to the actions of foreigners; not surprisingly, in most of the crises domestic residents and corporations played a prominent part in the capital-flow reversals.

What can be done to reduce the volatility of capital flows to emerging-market countries? The first response would be for countries to shut themselves off from international capital flows. It bears emphasis that *despite the crises, and the arguments of many critics of globalization, almost no country has taken this route; the*

<sup>54</sup> Following the Asian crisis, an IMF study concluded that a wide range of financial institutions, including banks, had engaged in the same behavior as the hedge funds (see Barry Eichengreen and Don Mathieson, 1998).

*revealed preference of the emerging-market countries is to stay involved with the international financial system.*<sup>55</sup>

However, as previously noted, some countries have taken measures to limit the offshore use of their currencies, thus securing more monetary-policy flexibility. In addition, I should note that capital-flow reversals would not have been so large had the inflows been smaller to begin with. The introduction of a flexible exchange-rate system has generally sharply reduced short-term capital inflows and is thus a major part of the solution to the problem of excessive capital-flow volatility. For transitional periods, the use of Chilean-style capital-inflow controls and more detailed reporting requirements can also help moderate inflows.

The question also arises of whether policy measures to mitigate the volatility of capital flows to emerging-market countries can be taken by the authorities in the major capital markets from which the funds flow. Many, including the authorities in some Asian countries, have argued for more transparency by the hedge funds and other market participants.<sup>56</sup> However it has not been possible to reach a consensus on greater disclosure of position-taking by financial institutions participating in emerging markets. Although it is doubtful that a different consensus will emerge any time soon, this issue should remain on the agenda—and in the meantime, it remains open to emerging-market authorities to build better information systems about capital flows in their countries.

Also prominent on the agenda is private-sector involvement in the resolution of crises. Let me briefly take up two issues: the extent to which the official sector should seek to coordinate the actions of the private sector when a crisis appears imminent, and the recent IMF proposal for a sovereign debt-restructuring mechanism.<sup>57</sup>

During the 1980's Latin American debt crisis, the Federal Reserve System and the IMF worked closely with the principal creditors, the banks, and the debtor countries to put together financing packages. As the 1990's crises unfolded, there were many who argued that the authorities should act similarly and seek to coordinate the creditors. In effect, the argument is that there is a bad equilibrium in which all the lenders seek to withdraw funds and only worsen the crisis in doing so, and a good equilibrium in which the creditors stay in and thereby help mitigate the crisis. In such situations, in coordinating the creditors the authorities can be seen as resolving a collective-action problem that the creditors acting individually cannot solve.

This approach was successful in the South Korean crisis at the end of 1997 and in early 1998. Nonetheless, great care needs to be taken in seeking to coordinate the creditors. It would be destabilizing if the creditors were coordinated in every crisis, for they would have a greater incentive to rush for the exits at the mere hint of a crisis.<sup>58</sup> In addition, it is much more difficult for the authorities to justify coordinating the creditors when there is a significant risk that those who have been persuaded to stay in will nonetheless suffer losses. That is why industrial-country regulators have been less enthusiastic about creditor coordination in recent years than they were in the 1980s: there is a conflict between their regulatory role and their pressuring the banks to maintain portfolio positions against their will.

The recent experience suggests a differentiated approach to creditor coordination. Sometimes a formal approach may be necessary, as in Korea at Christmas in 1997; at other times, as in the case of Brazil in March 1999, when the commercial banks voluntarily agreed to maintain their lines of credit, less formal discussions could serve better; when financing needs are small, or when an IMF package seems adequate

<sup>55</sup> Even Malaysia, which imposed capital controls in 1998, removed most of them within 1–2 years.

<sup>56</sup> For more detailed proposals, see Wendy Dobson and Gary Hufbauer (2001).

<sup>57</sup> For a more comprehensive analysis, see Fischer (2002).

<sup>58</sup> This possibility was very much in the minds of those contemplating coordinated action during the crises of the 1990's: we believed that the more often we sought to coordinate the creditors, the more likely it was that the crisis would spread even further than it did, and that in the limit the entire system could seize up, and we would have been back in the 1930's.

to reverse outflows, there may be no need to approach the creditors; and in extreme and infrequent cases, an involuntary restructuring of the debt may be necessary.

It is striking that, when governments face the decision on whether to seek to impose a standstill and/or restructure their debts in a nonvoluntary way, they are generally willing to go very far to avoid a default. Why? The reasons are: (i) that a debt restructuring will almost certainly involve a restructuring of the domestic financial system, where financial institutions (including banks and pension funds) hold government bonds as important parts of their portfolios; (ii) that there may be serious interruptions to the payments mechanism and to trade credit;<sup>59</sup> and (iii) that it is impossible to know when domestic and foreign confidence in the government's ability to meet its promises will be restored, and for how long the country will be punished by the markets for having defaulted. Rightly or wrongly, probably rightly, debtor governments see the costs of a debt default as extremely large—and much larger than the critics of IMF loans typically imply.<sup>60</sup>

A key problem is that we have no accepted framework in which a country in extremis can impose a payments suspension or standstill pending agreement with its creditors to support the restoration of viability—which takes us to Anne Krueger's proposal for a Sovereign Debt Restructuring Mechanism (SDRM), a legal mechanism to approve payments standstills by sovereign nations, and for the restructuring and, if necessary, writing down of sovereign debts.<sup>61</sup>

The costs of resorting to such measures have to be high if the international financial system is to work well. If creditors believe that emerging-

market debtors will too easily use legal provisions to restructure debts, spreads will rise, and capital flows to those countries will decline. That is why policymakers from emerging-market countries generally oppose proposals to make it easier for them to restructure their payments, be it through collective-action clauses or the creation of a sovereign bankruptcy procedure.

Based on their behavior during the last decade, I believe it unlikely that emerging-market economic officials will be encouraged to default by the presence of an SDRM, though some of them fear that it would change the balance of forces within the country, encouraging populist forces that often favor repudiating debts. Rather, an SDRM would be more likely to affect the behavior of the IMF and the official sector, which could become too quick to urge restructurings as an alternative to IMF lending. There is a balance to be struck, and it is important for the effective operation of the international system that the IMF not step back from providing financing to countries facing a liquidity crisis.

The SDRM proposal has already achieved success in leading the private sector to support the inclusion of collective active clauses (CAC's) in bond contracts. It is certainly desirable that the IMF continue its important work on the mechanism. But we should recognize that at best it will take years to change the legal framework, and that it is quite possible that it will not in the end be possible to persuade the U.S. Congress on this issue. In any case, I believe the Executive Board of the IMF should continue seeking to spell out more precisely a set of procedures for how it will act in the event it concludes that a country has an unsustainable level of debt. This would help formalize the approach that has already been developed on an ad hoc basis in response to some of the recent crises. At the very least, it would provide more clarity on the question for debtors and creditors alike, which would be a good in itself.

Let me turn next to what the emerging-market countries can do to reduce their vulnerability. The crises of the last decade can be seen as the manifestation of the impossible trinity in the emerging markets, 25 years after the Bretton Woods system succumbed to the same forces.

<sup>59</sup> The experience of Argentina so far in its current crisis suggests that creditor legal action following a default may be less disruptive than many, including me, had anticipated.

<sup>60</sup> It is the judgment of how far to go to help a country that seeks to avoid a default, and of what probability of success to require, that lies behind the controversies over recent IMF support for Turkey, its decision to support Argentina in August 2001, and not to provide further support in December 2001.

<sup>61</sup> National bankruptcy laws should apply to private-sector debtors who cannot make payments; if debtors can pay in local currency, the stay could permit a delay in converting these payments into foreign currency.



The adoption of flexible exchange-rate systems by most emerging-market countries is by far the most important emerging-market crisis-prevention measure taken in response.<sup>62</sup> In choosing a new nominal anchor to replace the exchange rate, most countries have (wisely, I believe) opted for inflation-targeting.

However, exchange-rate flexibility is not sufficient to prevent crises, for a country may nonetheless get into trouble because of market doubts about its ability to service its debt. This is the main cause of the 2002 crisis in Brazil. Even with a flexible exchange rate, excessive indebtedness of either the public or the private sector, and weaknesses in the financial sector, make a country more vulnerable to both internal and external shocks.

Hence, countries wishing to operate in the international capital markets need both to strengthen their financial systems and to ensure that their fiscal policies are sustainable. Fiscal sustainability requires not only that the debt to GDP ratio will stabilize if things go well, but also that the debt will be sustainable (possibly with the assistance of policy adjustments and the IMF) if the economy is hit by shocks. Fiscal-sustainability criteria for emerging-market countries have not yet been defined. However, it is likely that the Maastricht 60-percent debt-to-GDP threshold ratio is too high for countries subject to much larger interest-rate and other external shocks than are the industrialized countries.<sup>63</sup>

In criticizing IMF-supported programs, it is often remarked that industrialized countries can cut interest rates and run expansionary fiscal

policies when in recession but that the IMF does not recommend a similar course for emerging-market countries in crisis. If a country in crisis has a strong fiscal position and has no problem borrowing, then it can indeed run a more expansionary fiscal policy.<sup>64</sup> But many emerging-market countries that enter IMF programs are in a debt crisis, in which they cannot borrow from the market, and high interest rates are adding to adverse debt dynamics. The country cannot increase market borrowing in these circumstances,<sup>65</sup> and the international financial institutions (IFI's) do not usually have enough resources to more than offset the contractions imposed by the markets. Thus, fiscal policy has to be tightened if the country is to avoid a default—as virtually every country in crisis desperately wants to do.

As to monetary policy, if the country has few debts denominated in foreign currency, and inflation is low, then it can cut interest rates and allow the currency to depreciate. If, however, its currency is plunging, then a rise in interest rates is more likely than an interest-rate cut to slow or stop the collapse.<sup>66</sup>

As already discussed, in adapting themselves to living in the international financial system, countries need also to be cautious about when and how they liberalize capital-account transactions. Other measures include greater transparency about both data and the intentions of the government, and the adoption of international

<sup>62</sup> By a flexible exchange-rate system I do not mean a purely floating rate, but rather a system in which the authorities may intervene to affect the rate but are not perceived as trying to defend a particular rate or narrow range of rates.

<sup>63</sup> Several economists have pointed to what they call the original sin of emerging-market borrowers, that they are unable to borrow internationally in their own currencies. As Eichengreen and Ricardo Hausmann (2002) explain, had Brazil been borrowing in its own currency, investor uncertainty that caused the *real* to plummet would mainly have led to more competitive Brazilian exports, rather than a large increase in debt-servicing costs. I see no simple solution to the original-sin problem, beyond establishing a record that encourages creditors to accept the risks of lending in emerging-market currencies.

<sup>64</sup> As noted in Jack Boorman et al. (2000), the initial programs supported by the IMF in Asia, where government indebtedness was generally low, tightened fiscal policy excessively, though policy was relaxed within a short time. Policy was tightened because it was believed this would strengthen market confidence, and would serve as a down-payment on the expected costs of financial-sector restructuring.

<sup>65</sup> Mindful of the difficulties caused by tightening fiscal policy in a recession, the IMF in late 2000 agreed with Argentina on a small fiscal expansion, as a contribution to recovery. Political economy is complicated: we were told by some Argentines at the time that this was a mistake, not because Keynes was wrong, but because the government would use the extra room given by the IMF support to increase the deficit by more than the agreed amount. They turned out to be right.

<sup>66</sup> However, at some point, further increases in the interest rate become counterproductive, because they make debt dynamics worse and weaken the financial conditions of both financial and nonfinancial corporations.

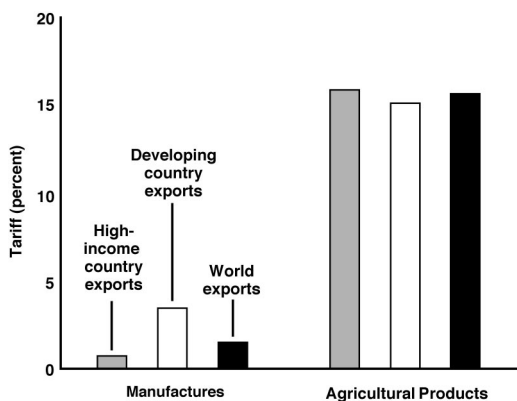


FIGURE 7. TRADE PROTECTION IN INDUSTRIAL COUNTRIES

Note: The figure shows tariffs on merchandise imported by high-income countries (as percentages) in 1995.

Source: *Global Economic Prospects 2003* (Ch. 6).

codes and standards with regard to the financial system, fiscal- and monetary-policy transparency, accounting standards, corporate governance, and so forth.

### E. The International Trading System

Reductions in tariffs and the growth in trade in the past half century have been greater among the OECD countries than between industrialized and developing countries. In particular, as is well known, agricultural protection in the European Union, the United States, and Japan discriminates against those goods in which many developing countries are relatively most efficient, and limitations on textiles exports (which are due to be removed in 2005) have a similar effect. Figure 7 illustrates this trade protection of manufacturing and agriculture in high-income countries.

The international trading system is biased against developing countries. In the wake of September 11, the Doha Round of trade negotiations was inaugurated and named “the development round.” It remains to be seen whether agricultural subsidization and protection in the industrialized countries will be lifted, and whether antidumping regulations and other non-tariff barriers will be eased. To be sure, reducing agricultural protection is politically difficult in the industrialized countries, but absent such

changes, the world trading system will remain unfairly tilted against the developing countries.

Figure 8 shows the results of a World Bank model simulation, which examines the long-term impact of full trade liberalization.<sup>67</sup> The dynamic gains calculation assumes that openness affects productivity. With or without this effect, the gains are impressive and are greater relatively and even absolutely for the developing countries than for the industrialized countries. Nearly half the benefits for the developing countries come from the liberalization of agricultural trade.

One other result bears emphasis. A consistent finding of such studies is that at least half the gains for the developing countries derive from greater intra-developing-country trade, that is, South–South trade. In other words, the developing countries would benefit not only from the industrialized countries opening up to their exports, but also from opening up their markets to each other.

Of the many measures that could be taken to make the international system work better and more fairly, removing the bias against developing-country exports and further South–South trade liberalization would be among the most effective.

### F. Aid

Over the period 1990–2000, the percentage of their GDP given as aid by industrialized country governments fell from 0.33 percent to 0.22 percent.<sup>68</sup> The total amount of aid is about \$60 billion, and donor governments are committed to seeking to raise aid’s share of their GDP by 2015. The share of 0.7 percent is a norm, but only Scandinavian countries and the Netherlands come close to meeting this ratio (and they all exceed it).<sup>69</sup> For the developing countries as a whole, net private capital flows far exceed aid. But for the group of the 44 least-developed countries (32 of them in Af-

<sup>67</sup> These results are presented in *Global Economic Prospects 2003* (Ch. 6).

<sup>68</sup> Net grants by NGOs added another 0.03 percent of donor GDP to the total in each year.

<sup>69</sup> In 2002, Luxembourg gave 0.71 percent of its GDP in aid.

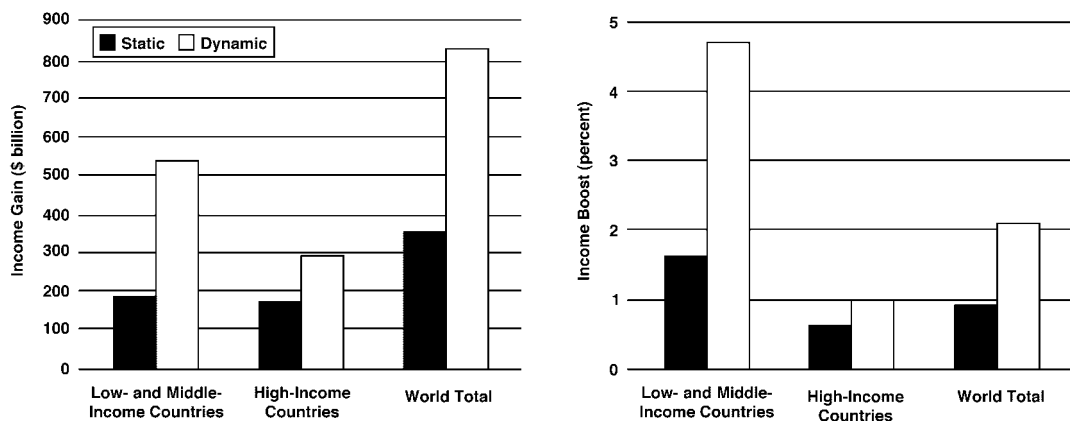


FIGURE 8. LONG-TERM IMPACT OF FULL TRADE LIBERALIZATION

Notes: The figure shows that developing countries could reap income gains of more than \$500 billion from full trade liberalization, which implies up to a 5-percent boost in incomes. The left-hand panel shows additional income in 2015, in terms of 1997 dollars, compared with the baseline. The right-hand panel shows the income boost as a percentage of baseline income in 2015. Static gains refer to the results holding productivity constant. Dynamic gains allow productivity to respond to sector-specific export-to-output ratios.

Source: World Bank model simulations.

rica), foreign aid (at 7.6 percent of GDP) is three times larger than private flows.<sup>70</sup>

The 0.7-percent norm has been in existence for decades, while aid has continued to fall. Underlying the rationale for the decline has been growing skepticism about the effectiveness of aid, abetted by the continuing emphasis by those in the development business on remaining problems rather than achievements. Corruption in some of the recipient governments has also severely reduced public support for aid. In addition, the way the aid process has worked has created an aid dependence in some of the poorest countries that has inhibited their taking action to solve their own problems.<sup>71</sup>

Among the new approaches now being implemented is greater selectivity, both among countries and in the focus of the aid effort

<sup>70</sup> There are several small and very poor countries that receive more than 20 percent of GDP in aid. Data are available in the *Human Development Report*, based on Development Assistance Committee reports (United Nations Development Program, 2002).

<sup>71</sup> There is also a selection bias in the evaluation of aid. The countries that used aid most successfully at earlier stages, including, for example, Korea and Taiwan no longer count in the evaluation of aid.

within a country.<sup>72</sup> The millennium challenge approach set out by the United States, in which countries will have to compete for extra aid, is an interesting and potentially important experiment. In terms of focus within countries, there is an increased emphasis on health and education spending. Greater reliance on NGOs to deliver aid is another—but the proliferation of NGOs has also fostered aid dependence.

The new (as of 2000) approach of the IMF and the World Bank, in which countries are supposed to take the lead in preparing poverty-reduction strategy plans, in cooperation with their aid partners, could help deal with the problem of aid dependence, but the evidence on the success of the new approach is not yet in. This approach reflects the evidence that economic programs are more likely to succeed when they are owned by those implementing them—which is to say that the government regards the program as its own rather than an imposition of the aid-givers, and the government has public support for the program.

<sup>72</sup> See World Bank (2002b) for recommendations (including greater selectivity) for making aid more effective.

One problem inherent in approaches that penalize governments for bad behavior, and that makes aid such a difficult area, is that when aid to a country with a bad government is cut off, most of those who suffer are private citizens, who are already suffering from poor government. Hence humanitarian aid generally does and should continue even in cases, like Zimbabwe, where the humanitarian crisis is caused by the actions of the government. Jeffrey Sachs and others (see World Health Organization, 2001) have also made a powerful case that the very poorest countries should receive large amounts of aid, to enable them to improve health, education, and infrastructure, as part of an effort to jump-start development.

As countries develop, private capital flows augment and then replace aid. But private capital barely flows to the poorest countries, and solutions to the plight of those living in the very poorest countries, which have a population of about 650 million, will require major external assistance. It is hard to believe that a successful attack can be made on global poverty with continually declining flows of aid—though some of the new approaches should make that aid more effective than it has been in the past.

### G. Reform of the IMF

As a result of the crises of the last decade, and its own internal dynamics, the IMF has laid out an agenda of reform.<sup>73</sup> The agenda includes more focused conditionality, with an emphasis on macroeconomic policies and those structural measures essential to macroeconomic stability, and greater efforts to ensure country ownership of programs. The Fund is also seeking to improve its surveillance, as part of an overall effort to help prevent crises.

Rather than discuss Fund reform in detail,<sup>74</sup> I want to concentrate on one issue that has received a great deal of attention in recent discussions about the IMF, that of its accountability. The charge is often made that the Fund is a

secretive organization, with no real accountability. In the past the Fund may well have been too secretive for the good of its member countries or its own good. But there has been a sea change in the Fund's transparency, and the charge of secrecy is no longer valid.

As to accountability, *Fund management is accountable to the shareholders, the member governments*, who are represented in the Executive Board. The Board discusses and votes on all loans and all Fund policies. The largest shareholders have individual representatives; other countries are grouped into constituencies, with one Executive Director representing all the countries in the group. Voting is weighted by the number of shares of the country or countries the Executive Director represents.

These shares, the quotas, are proportional to the amount the country has to contribute to the Fund. Thus the largest contributors have the largest share of the vote, which means the United States, with over 17 percent of the contributions, has far and away the biggest share of the vote. The quotas not only determine the country's share of the total vote, but they are also a norm for the amount a country can borrow from the Fund.<sup>75</sup>

The member governments, through their Executive Directors (and sometimes directly, in discussions with the management) play an active role in Fund decision-making.<sup>76</sup> Because the management needs Board support for its proposals, it consults with Board members well before an issue reaches them for formal discussion. Although the management rarely loses votes in the Board, this is mainly because it does its homework and does not take issues on which it expects to lose to the Board.

I regard the accountability of the Fund's management to its member governments, and the weighted voting, as both fundamental and appropriate. It has been suggested that the Fund management should be more independent, along central-bank lines. But this misunderstands the nature of Fund lending activities,

<sup>73</sup> See for instance the speech of the then new Managing Director at the Annual Meeting in Prague in September 2000, available online: (<http://www.imf.org/external/am/2000/speeches/PR03E.pdf>).

<sup>74</sup> That is done in Fischer (2001).

<sup>75</sup> For example, borrowing in excess of 300 percent of quota is regarded as "exceptional access."

<sup>76</sup> The Board of the Fund is generally viewed as more involved in Fund decision-making than the Board of the World Bank in Bank decisions.

which inevitably have a political element to them—and on which, the governments who are funding the loans should ultimately decide. In negotiating programs, I took great comfort from the management's accountability to the Board, for without the legitimacy provided by the need for backing by member governments, it was not clear what authority a bureaucrat like myself would have had for undertaking such negotiations.

As to the weighted voting, the Fund is committing the resources of its member governments when it lends money, and I believe those who provide more of the resources should have a bigger say. The one-country, one-vote alternative would put the borrowers in charge of lending decisions, which is not a good principle on which to run a financial institution. However, the present quotas are not optimal, for there are countries whose actual quota is far from representative of their role in the global economy.

It has also been suggested that the Fund staff and management should be more accountable to the citizens of the countries receiving loans. Increasingly, Fund staff has tried to ensure that the citizens of the recipient country are well informed about the details of loans, and it encourages the borrowing government to publish the relevant documents. Many of them do so, and all should do so. Ultimately though, Fund loans are to member governments, and it is the governments that make the decisions and that should be accountable to their citizens.

It has also been suggested that the Fund should consult more with outside academics and experts. In the normal course of business, the Fund does from time to time hold organized meetings with outside experts on specific issues, regions, and countries. There is less time for formal consultative meetings when a program is being negotiated. But as negotiations proceed, the staff and management do consult informally with academic and other experts whose judgment and discretion they trust.

Many others would like to be heard and take part in the discussion as the Fund thinks through and negotiates its programs. To the extent time allows, the Fund should be open to those discussions. But not everyone who wants to be heard has a legitimate role in the process. Some of the borrowing countries have objected strongly

to the formalization of the role of NGOs and civil society in the Poverty Reduction Strategy Papers, arguing that as democratically elected governments, it is for them to represent their country and the views of its citizens.

In brief, the Fund is and should be accountable to the governments that are its members. It should be as open and as transparent as possible about its activities, and it has moved a long way in that direction in the last decade. It should be as open as possible to discussions with members of civil society constructively interested in the issues it deals with. But its decision-making processes should remain inter-governmental, with the primary responsibility for reflecting the views of civil society on each issue and in each program being taken by member governments.

#### IV. The Challenges

The overall challenge to economic globalization is to make the global system deliver economic growth more consistently and more equitably, as the best way to further reduce global poverty and inequality. The specific challenges to globalization are both region- and subject-specific.

Global growth is determined mainly by the performance of the industrial countries.<sup>77</sup> After the current adjustments are done, the United States and, less certainly, Europe should be able to resume growth at rates in the range of 2–4 percent. The prospects for Japan are more difficult: with decisive action to deal with its weak banking sector and associated corporate-sector problems, Japan can return to modest but positive growth; without such action Japan is likely to continue its present dismal performance, with a chance of a crisis ever present. The choice is Japan's, for the nature of the problem and the choice are well understood.

Attitudes to globalization in the industrialized countries will be key to the future of the global economy. Hence, governments in those countries need to stand up and support the right

<sup>77</sup> The IMF calculates global growth by weighting country growth rates by purchasing-power-parity estimates of GDP, which leads to a higher growth number by enhancing the role of the developing countries (including China and India) in the estimate.



policies, help their own people deal with the adverse consequences of economic change, and deliver on their promises on trade, aid, and the strengthening of the international economic system.

In Asia, where South Korea has already led the way, China and India are well launched on the path to sustainable growth, and it is reasonable to expect growth to continue to spread through the region—though we should not forget that some countries in Asia are among the world's poorest. Nor should we forget that India's growth could accelerate if it intensifies its macroeconomic stabilization and reform efforts. Most of the former Soviet-bloc transition economies, most importantly Russia, have turned the corner from decline to growth, which is likely to continue if policies stay on track.

Latin America made a promising start toward sustained growth in the first half of the last decade. But then there were major crises in the three biggest economies in the region: Mexico, Brazil, and Argentina. South America's economic prospects are tied to the fortunes of Brazil, which faces a difficult but manageable economic situation. If the new government succeeds while maintaining both macroeconomic stability (and this is an issue on which it has insisted) and deepening its links with the rest of the world, while at the same time increasing social spending, that would help solidify the ongoing transformation of the economic policy approach in Latin America. The stakes are very high, but the answers in terms of the right general orientation of policy seem clear. Successful negotiation of a free-trade area of the Americas would help secure the economic gains that the region is close to achieving.

There is relatively little poverty in the Middle East. But the countries of the region, the oil-producers included, face formidable economic development challenges, many of them a result of the pressure of rapid population growth. Whether governments can meet those challenges, and the associated challenge of democratization, will affect not only the economies of the Middle East, but also peace in the Middle East and the rest of the world.

The challenge of development is most profound in sub-Saharan Africa, which has by far the highest poverty rate, and where the number

of poor has been rising rapidly. There have been success stories in Africa, including for a long time Botswana and Uganda, but success has been fragile. The economic future of southern Africa will be determined by developments in South Africa, whose economic policies during the past eight years have been very good, but where the HIV/AIDS problem and events in Zimbabwe have cast multi-dimensional shadows.

Some countries in Africa are beset by problems of governance, which are exacerbated by poverty, wars for control over mineral wealth, and in some cases ethnic fragmentation. The problems of Africa can only yield to a combination of domestic political and economic reform and outside assistance. The creation of the NEPAD, the New Partnership for African Development, is an encouraging sign of African determination to take the lead in solving their own problems. But a great deal of further work needs to be done to make NEPAD succeed.

In turning next to the national and global policy challenges, I shall be summarizing much of the material presented to this point.

#### *A. Implementing the Right Policies*

The outward-oriented policies described in the 1990 Washington consensus remain an important component of the right approach to economic policy.<sup>78</sup> That policy approach needs to be enhanced by: first, a greater emphasis on social justice, to be implemented through health and education spending, social safety nets adapted to the economic structure of the country, and infrastructure spending; second, greater attention to developing the institutions of effective economic governance, including efficient judicial systems, civil service, the tax system, and other elements in the enabling environment for private-sector activity; third, more attention to crisis-proofing the economy, especially by strengthening the financial system, and macroeconomic policies; and fourth, labor-market reform to allow a greater proportion of the workforce to enter the formal labor market.

<sup>78</sup> I am grateful to John Williamson for discussion and for allowing me to draw on a draft paper on the policy lessons of the last decade (Williamson, 2002).

### B. *Delivering on Trade and Aid*

The industrialized countries need to deliver on their part of the bargain that tells developing countries that they should integrate into the global economy. In particular, that means liberalizing agricultural trade and ending the massive subsidies to agriculture that impair the exports of so many developing countries. It means also making a success of the Doha development round. At the same time, the developing countries can achieve major gains by opening up trade to each other.

The aid process needs to be made more effective through greater selectivity among countries and sectors within countries and through countries taking greater ownership of the process. But at the same time it is hard to see the problems of the poorest countries being solved without significant increases in aid.

### C. *Making the International Financial System Less Crisis-Prone*

The shift to flexible exchange rates 30 years ago, and the strengthening of macroeconomic policy frameworks since, which has removed the inflation problem, have helped prevent foreign exchange crises among the industrialized countries.<sup>79</sup> But the system is still disturbingly crisis-prone for the emerging-market countries. Measures are being implemented to make the system more stable for the emerging-market countries. The most important of these is the shift to exchange-rate flexibility—but crises can erupt for other reasons, particularly market fears of an unstable debt dynamics, and the strengthening of domestic policies and institutions is essential.

### D. *Dealing with Migration*

Migration of labor and temporary labor flows are playing an increasing role in the global economy. They are a potentially powerful force

<sup>79</sup> In fact, exchange rates among the industrialized countries moved in bipolar fashion, with members of EMU pegging in the hardest possible way by eliminating their own currencies, and all other exchange rates becoming flexible.

in the global economy, for good (in helping produce convergence of income levels among countries if it is the unskilled who migrate) or ill (because of possible brain-drain effects). This is an area where national economic, social, and cultural preferences are bound to take a front seat. But it is also an area where greater clarity is needed on the economic effects of alternative policies, and where, eventually, more public policy attention will be focused (see e.g., George Borjas et al., 1997; Barry Chiswick and Timothy Hatton, 2003).<sup>80</sup>

### E. *Improving Governance*

It was often said during the mid-1990's that "we cannot want reform more than the Russians do." The same applies everywhere. Ordinary people everywhere want to improve their lives. But corrupt governments do not necessarily respond to those desires. That is why the trend to democracy is so important. It is also why global term limits are a good idea, even though I have no idea of how to enforce them—but I have seen no government improve after ten years in office.

While countries are primarily responsible for their own fates, outsiders from both the public and private sectors can help influence the outcome, by promoting democracy, by economic investing, and by supporting good projects in social sectors. Through their actions they can also help fight corruption in developing countries.

### V. *Concluding Comments*

In thinking about the globalization debate, and considering that the proponents of globalization recognize the need to deal with most of the problems to which the critics point, I am sometimes tempted to conclude that the debate is mainly a matter of temperament—between those who see the glass as half full versus those who see it as half empty; those who see the doughnut and those who see the hole; or those

<sup>80</sup> Bhagwati (2003) points to the importance of migration and suggests the establishment of a World Migration Organization to coordinate international policy on these issues.

on the inside who are in a position to influence policy directly and those who, for whatever reason, are outside critics. But then I reflect that the debate will affect economic policies in both industrialized and developing countries, and I realize again its critical importance for the economic future.

In developing that argument, I will quote two of the greatest Englishmen of the last century. The first is John Maynard Keynes, the young Keynes who in 1919 (pp. 9–10) said:

What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! ... The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality ... .

This paean of praise would place Keynes safely among the extreme globalizers. But then comes his warning:

But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable. The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent to this paradise, were little more than the amusements of his daily newspaper, and appeared to exercise almost no influence at all on the ordinary course of social and economic life, the

internationalisation of which was nearly complete in practice.

Some argue that globalization is driven by technology, and that it represents an unstoppable force. Perhaps—in the long run. But we economists know that the forces of globalization were stopped and reversed for nearly a third (the worst third) of the last century. As the words of Keynes remind us, we cannot take it for granted that the world will continue down the road of globalization, greater prosperity, and greater democracy. That may be an astonishing thing to say at the end of a century that witnessed the first sustained competition between two clearly defined economic and political systems, and in which the pro-democracy, pro-market, pro-globalization system won that contest decisively. Nonetheless that system is under attack.

The attack is about much more than economics, and it could well be that the issues we have discussed tonight are not the decisive ones. Rather, political, cultural and religious forces could play the dominant role in shaping the future of globalization. As concerned and well-informed citizens we can participate in and try to shape the broader debate.

But we have special obligations as professional economists participating in the debate over economic globalization:

- (i) to maintain our professional standards;
- (ii) not to be afraid to take on big untidy issues, but to do so objectively, element by element;
- (iii) to keep trying to find solutions to real world problems; and
- (iv) from time to time—to stand up and be counted on the issues.

The world and the economic system we live in are highly imperfect. There is much that needs to be done to make them work better. But as we do that, we should maintain a perspective that reflects what Winston Churchill said of democracy:<sup>81</sup> The pro-market pro-globalization

<sup>81</sup> “Democracy is the worst form of government, except for all the others that have been tried.”

approach is the worst economic policy, except for all the others that have been tried.

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