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Opening Space for Development

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Introduction

In the past, countries had national development strategies. Even though the external sector could play an important role, the basic dynamics for development was seen to come from within countries (Sunkel, 1993). In the 1990's, the new development strategy became liberalisation, and in particular integration into the global economy. The basic indicators for a "successful" development strategy became how much the trade and capital account had been opened up, how much the financial sector had been liberalised, how much the economy had been privatised. Indeed, globalisation and liberalisation became the new development agenda.

To some extent, this new development strategy arose from external pressures. A particularly high profile in the analysis has been given to influence via IMF and World Bank conditionality. However, perhaps more important - and increasingly so - is the pressure arising from "financial markets," which heavily influence both development strategies and macro-economic policies. Governments increasingly follow policies that are not necessarily the best for their economies or their peoples, but that are "acceptable to the markets" because if they do not do so, they will be implacably punished by those markets (Eatwell, 1997). However, the shift towards a rather pure liberalising and globalising agenda by most developing countries arose not only from external pressures, but also reflected the widespread view in many of the developing countries (and particularly amongst their governing elite) that market reform and, particularly, opening the economy to global links would lead to faster growth and higher investment and employment. Implicitly, there was a belief that countries which reformed well would significantly increase their exports and attract large and stable external capital flows, which would complement domestic savings and help increase productivity.

Unfortunately, many - or indeed most - of the hopes were not fulfilled. As Ocampo (2001) points out, perhaps the most serious blow to this strategy came from the East Asian - and other emerging market - crises. The East Asian countries - that had been the "tigers" of development - saw their economics shaken, and even undermined, by massive reversals of capital flows, that caused huge macro-economic instability, declines of GDP and increases in poverty, etc. Short-term capital flows were increasingly seen by a wide variety of observers as "the Achilles' heel" of globalisation (Griffith-Jones and Kimmis, 1999).

Even though most of the East Asian economies recovered, they are still struggling with the repercussions of those crises in the financial sector. Emerging markets - Brazil, Argentina, Turkey - and possibly others - were hit, or are being threatened, by new financial and currency crises. To avoid such crises, they are being continually obliged to follow deflationary fiscal and monetary policies, which restrict their ability to grow. Argentina's evolution during the last three years illustrates those problematic trends. Contagion threatens to undermine other countries, even if they are perceived to have "good fundamentals".

More broadly, growth under the new model has been disappointing. Latin America - the region where economic reforms were implemented earlier and with most enthusiasm - has only grown at a 3.2% a year in the 1990's. That is at a far lower rate than the 5.5% growth achieved in the 1950's to 1970's.

The new millennium does not start with a more promising outlook, on the contrary, the sharp slow-down in the US, the continued negative level of private flows (except FDI) to developing countries, and the problems in Argentina - and their influence on other countries - threaten a poor performance for Latin America for 2001. Positive trends in Latin America during the 1990's have been interrupted several times by crises, originating either within the region or outside. There was the 1994/5 Mexican peso crisis and the tequila effect on Argentina and the rest of the region. There were the 1997/8 effects of the East Asian and Russian crises; there was the 1999 Brazilian crisis. There have been the problems in Argentina with their impact on Brazil, Chile and others.

Indeed, if we look world-wide during the 1990's, there have been serious currency crises during 33% of the time (in 40 of the 120 months of the decade). Instead of being the exception, crises are almost normal.

From a development perspective, this situation is unacceptable; the international context undermines - instead of supporting - development. Volatility of capital flows, and the impact this has on the macro-economy, significantly reduces growth, investment and poverty reduction.

There are two options for a more favourable outcome. The first would be to reform the international financial system so it can help sustain stable, sufficient and broadly distributed private finance to developing countries. This would imply that governments - especially G-7 ones - themselves catch up with globalisation, and deliver the global financial governance necessary to help smooth private flows, make them sufficient and sufficiently long term.

The key challenge is to develop at a global level institutional mechanisms, that were developed in the past at national levels as domestic credit and capital markets grew. Given the globalisation of finance and capital flows, a new international financial architecture requires:

a) Appropriate transparency and regulation (including counter-cyclical elements) of international loan and capital markets.
b) Provision of sufficient international official liquidity in distress conditions for both middle-income and low-income countries.
c) Standstill and orderly debt workout procedures at an international level and,
d) Sufficient official development finance, for countries and sectors that cannot receive private flows.

(Please see enclosed paper for a recent discussion of a possible blueprint). However, as also discussed in the enclosed paper, there are important obstacles to be overcome for implementing a significantly new financial architecture, that could support development. Useful steps have been taken, but they were insufficient. Indeed, recent moves - such as the suggested new Basle Capital Accord - could worsen recent trends by making international lending to developing countries significantly more expensive and far more pro-cyclical. (See Griffith-Jones and Spratt, 2001). Equally worrying are signals that the new US Administration could reduce long-term support to development lending via development banks, by transforming IDA loans into grants.

Developing countries clearly need to maximise efforts to try to bargain for a better international financial architecture. Suggestions and strategy are made in the enclosed paper.

However, if progress is not made soon, or worse if there are reversals in the existing financial architecture that would make it even less supportive of development, developing countries may need to seriously re-think their development strategies. This would imply two elements; firstly take measures (such as limiting or slowing down opening of the capital account), to protect themselves from volatility and reversals in capital flows; secondly, increase reliance on domestic policies that would generate growth "from within." This is what Ocampo, op.cit has called "active productive development policies" and Rodrick (1999) has called a "domestic investment strategy" to kick-start growth. This implies strong government business investment, innovation and strategic complementarities. Clearly this would differ significantly from the import substitution industrialisation strategies of the past, as they would need to respond to new trends and features in global economic development.

The liberalisation and market reforms that has characterised recent decades has clearly had some positive aspects. However, it has also implied a dismantling of many national government policy instruments, such as some selectivity in private credit policies, or some role for efficient development bank lending. This leaves economic authorities without sufficient policy mechanisms to support the private sector in a productive development strategy. Therefore, in a new development agenda, urgent thought needs to be given to the creation of new policy mechanisms that can help provide public resources and incentives to provide such support and guidance to the private sector.

It is also important that both public - and especially - private activity and investment can be sustained in time, and that boom-bust patterns that have characterised the nineties can be avoided. The above discussed changes in the international financial architecture are an essential pre-condition. Also important are domestic macro-economic policies that are not only prudent, consistent, but also balanced (thus avoiding large imbalances in the current account, whether caused by the public or private sector); the latter may require the introduction of new elements of counter-cyclical macro-economic policies, to compensate for inherent tendencies for boom-bust patterns. Equally important, counter-cyclical elements need to be introduced into domestic financial regulation, so as to discourage the natural tendency of financial sectors towards cycles of euphoria followed by disenchantment; more broadly, financial supervision and regulation - and especially its' implementation needs increased attention, to avoid costly financial sector crises, which are so negative for growth and development.

Greater emphasis on "development from within" would be particularly essential if the international financial system (IFS) is not reformed. However, it would be very valuable even if the IFS were reformed. In that latter case, hopefully a positive dynamism would be generated by the interaction of sufficient and sufficiently stable private flows to developing countries and to quicker domestic growth potential generated from national efforts.