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# Globalization and *loss of autonomy by* the fiscal, banking *and monetary authorities*

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The idea that globalization impairs the sovereignty of the modern nation-State is increasingly accepted in some academic, government and international circles. Currently, there is generalized concern over the progressive erosion of national authorities' leeway for making decisions on matters of internal interest independently of outside influences. This perception has reached its extreme among those who feel that globalization has transformed the nation-State into a dysfunctional entity in a world without frontiers. It is understandable that a consensus should have grown up around this thesis, in view of its general nature and in particular because of the conceptual flexibility with which the notions of globalization and sovereignty are usually treated in some professional circles. The term globalization is frequently used in the fields of communications, culture, politics and economics, while the notion of sovereignty is current in the political and military areas, whence it has been extended to apply to economic matters too. This paper examines the thesis in question, restricting it to the economic sphere. Even in this limited form, there is a certain lack of clarity in the idea that globalization of the economy curtails the autonomy of the authorities responsible for economic policy, since there is no single, or at least generally prevalent, interpretation of the concept of globalization within the field of economics. Similarly, the fact that the concept of autonomy did not originate in the economic sphere means that it is used with some latitude. In order to analyse the content, scope and limitations of the thesis, various examples are drawn from the areas of banking, monetary, exchange-rate and fiscal policy.

# I

## A characterization of the process of economic globalization

The phenomenon of globalization is arousing considerable interest in a number of professional circles, and it is understandable that this expression should be used in several ways. Moreover, the empirical rule that a range of opinions among economists is always positive is as applicable here as anywhere. It is thus necessary to explain the concept of globalization adopted in this study.<sup>1</sup>

The characteristic feature of the type of globalization referred to here is the gradual erosion of the territorial basis of economic activities, as industries, sectors or entire production processes – whether real or financial – begin to operate increasingly independently of the specific resources of a particular national territory. Under these circumstances, the location of the various operations of a corporation becomes a variable option for the hierarchies of the transnational corporations.<sup>2,3</sup>

The gradual lessening of the dependence of economic activities on territorial considerations has a number of causes, whose relative importance varies according to the field, sector and industry in question, and also from country to country: they have to do with the pattern of technical progress, consumer preferences, corporate organization and the public policies of national government. At all events, the

increase in factor mobility (particularly capital mobility) encouraged by these trends allows the corporate hierarchies to select and juggle with territories within the “global village” without loss of efficiency, competitiveness or profitability (figure 1).

Figure 1 allows us to distinguish analytically between two phenomena which habitually appear in conjunction, since each one to a greater or lesser extent reflects and conditions the progress of the other. First, an increase in the degree of openness or internationalization of the national economy (or a sector of the economy) can be interpreted as a South-North movement (typically from quadrant 3 to quadrant 1). Second, globalization of an industry or sector is an East-West movement (typically from quadrant 1 to quadrant 2). When the latter movement occurs simultaneously in a significant number of industries or countries, we talk of globalization of the world economy.

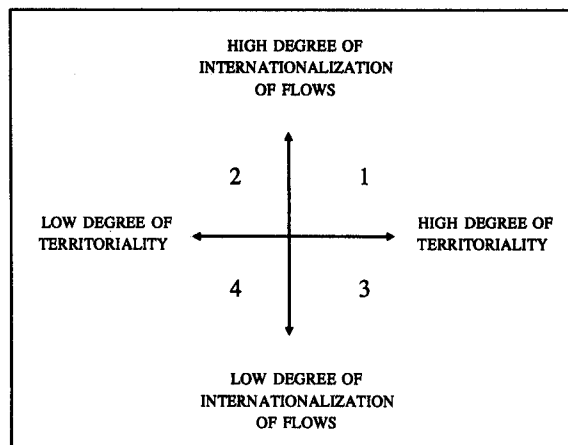
From a broader perspective, globalization is a microeconomic process of dynamic interaction between corporate hierarchies and markets, characterized by increasing interdependence between and

<sup>1</sup> On the concept of globalization, see the more exhaustive descriptions of Baumann (1995), Di Filippo (1995), Oman (1994) and Storper (1995).

<sup>2</sup> This is the characterization given by Storper (1995). The specific “assets” of a territory range from natural resources (mineral deposits, tropical forests, unskilled labour, etc.) to resources which have been “constructed” by humans, such as the availability of “symbolic analysts”, financial centres, networks and other computer services, airports, highways, favourable regulatory standards (flexible labour markets, etc.) and preferential tax treatment (tax incentives).

<sup>3</sup> Throughout this study, a distinction will be made between the market and the corporate hierarchy (considered as the structure of control and government of an organization), using Williamson’s idea that “hierarchies are no more than the continuation of market relations by other means” (Williamson and Winter, 1991).

FIGURE 1  
International flows and territoriality  
in economic activities



Source: Prepared by the author.

within companies and industries, which links corporate organizations and integrated markets throughout the world. However, from the standpoint of this essay, the essential characteristic of globalization is the progressive "de-territorialization" of economic activities.<sup>4</sup>

Analysis of the process of globalization is further enhanced when globalization is seen as the result

of complex evolutionary processes which began in a rather remote past.<sup>5</sup> Thus, for example, the growing intensity of flows –of trade, foreign direct investment, short-term capital, technology– which accompanies, reflects and conditions the process of economic globalization should be interpreted as the acceleration of a historical process whose roots can be discerned in the last century.<sup>6</sup>

## II

### Determining factors in the globalization process

The phenomenon of the globalization of the world economy is based on trends in at least three determining factors: technology, corporate organization and public policies.

In recent decades, the interaction of these key factors has increased noticeably and their mutual reinforcement and feedback have constantly extended the globalization process. A brief review of each of these factors is given below.

#### 1. Technology

Of the two routes to growth –by mobilizing resources such as investment, demographic dynamics, education of the workforce, etc., or by making more efficient use of resources through the incorporation of technical progress– the second is generally preferred now. At the same time, raising total factor productivity is a task which entails ever more intensive use of knowledge, and it is therefore understandable that a variety of organizations –from transnational corpora-

tions to national governments– are focusing increasing attention and effort on promoting the development, dissemination and adoption of new technologies.<sup>7</sup>

It is thus hardly surprising that during the last two decades the world has seen a spectacular wave of innovation in key areas, the most important of these being microelectronics and information technology. Separate and joint applications of innovations in these two areas have had a very favourable effect on the costs of activities with high "synergic" potential (communications, storage, information and data transfer, and transport in general).<sup>8</sup>

<sup>4</sup> Oman (1994) identifies two uses of the term globalization. The first refers to a microeconomic process: here analysis concerns, for example, issues of international competitiveness. The second use stresses the notion of globalization as a synonym for multilateralism: here, analysis is oriented towards issues of trade policy and, in particular, agreements on the system of world trade, such as the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). These, together with an agreement on trade in goods (which basically implements the standards established under GATT), are the pillars of the new World Trade Organization (WTO), which was born of the Uruguay Round.

<sup>5</sup> On the nature of evolutionary processes in economics, see Nelson and Winter (1982), Nelson (1995) and North (1990); on the discontinuities see Gerschenkron (1966).

<sup>6</sup> These roots include, notably, i) the legitimizing function of the doctrine of "free" trade inherited from David Ricardo; ii) the reduction in production and transport costs stemming from the innovations which followed the industrial revolution; iii) the consolidation of a system of "nation-States" rooted in legal frameworks compatible with private property rights, and the institutional arrangements that cut transaction costs; iv) the determination, on the part of the colonial powers of the time, to implant "free" trade and ensure the openness of markets, by force if necessary. A shining example of the latter was the so-called "opium war" (1839-1842) waged by Great Britain against China to force the Chinese to open their doors to the opium trade (and, in the process, to make Hong Kong into a British colony from 1842 to 1997).

<sup>7</sup> On the relationship between growth and the adoption of technologies, see Parente and Prescott (1991). Other excellent recent contributions to the economic analysis of the spread of innovation may be found in Freeman (1994), Stoneman and Diederer (1994), Metcalfe (1994) and Rosenberg (1994).

<sup>8</sup> The great economic impact of the spread of innovations in the area of new materials, microbiology and biotechnology is compounded by the enormous potential displayed by the "information technologies" (IT) resulting from the combination of computation, microelectronics and telecommunications in many sectors of the economy. For more details on this, see Milgrom and Roberts (1990), Alcorta (1993) and Rosenberg (1994).

This type of technological progress is exactly what the corporate hierarchies need in order to develop and consolidate the microeconomic dimension of the globalization process. This progress makes it possible to shorten distances, save time, reduce size and weight, greatly improve accuracy and quality, add or remove components and, ultimately, attain an explosive expansion of the options available to those hierarchies. Thus, corporations have total flexibility in deciding how to organize themselves, what and for whom to produce, and how, when and where to do so. The progressive de-territorialization of economic activities therefore owes much to technological innovation.

## 2. Corporate organization

The great reduction in production, marketing and transaction costs brought about by the incorporation of technical progress of this type opened the doors to the adoption of new models of organization on the part of the transnational corporate hierarchies (both in the real and the financial spheres of the economy). The favourable synergistic effect exerted by the combination of highly advanced technical innovations and sophisticated organizational systems characterized by their flexibility has made a crucial contribution to the consolidation of the economic globalization process.<sup>9</sup>

While in the recent past the strategy of transnational companies was often to set up a small-scale copy of the original company in the countries where they began operating, the new organizational model tends to locate operations (production, supply, publicity, legal advice, accounting, auditing, inventory control and handling, product and process research and development) in different territories around the world.

<sup>9</sup> As Freeman (1994) points out, any technical innovation of importance involves changes in the organization of production and of the markets. Similarly, organizational innovation can lead to important technical innovations (classic examples are the creation of the assembly line, the introduction of containers, self-service cafeterias and supermarkets and hypermarkets). The current phase of globalization is noteworthy, among other aspects, for the special, intensive interaction between technology and a system of production that is integrated on a global scale and which, as far as the major corporate functions are concerned, is structured around a sophisticated international distribution of intra-company tasks. On this topic see UNCTAD (1993) and Oman (1994).

The new system of "flexible" production seeks to locate each corporate function in the most suitable place, in order to exploit the comparative advantages of each territory.<sup>10</sup> Selecting the optimum combination of locations for the various functions or operations is the same as constructing advantages since, among other things, it allows corporations to: i) obtain cheaper or better-quality suppliers or ones that are closer to the centres of production; ii) locate production plants strategically in relation to major centres for the sale or consumption of their products; and iii) use more suitable technologies, independently of their country of origin. This is very similar to piecing together a gigantic jigsaw puzzle, where the final picture, like the position of the pieces themselves, may vary depending on the requirements of a corporate strategy which aims to ensure the competitiveness and profitability of the organization as a whole.

The economic superiority of this organizational model stems from its flexibility and the fact that it can adapt to generally changeable and rather unpredictable circumstances, thus allowing the corporate hierarchies to improve the efficiency and productivity of their organizations by giving them greater exposure to global competition (i.e., pitting them against the best practices of the best producers, in the most sophisticated and demanding markets, wherever they are located).<sup>11</sup>

<sup>10</sup> For a recent evaluation of various possible sources of comparative advantages, see Dollar (1993), Leamer (1993), Tybout (1993) and Hummels and Levinsohn (1993).

<sup>11</sup> Baily and Gersbach (1995) studied the considerable variations in productivity (measured as value added per hour) observed in nine industries (automobiles, auto parts, metal products and machinery, steel, computers, consumer electronics, foodstuffs, beer and soaps and detergents) in the United States, Germany and Japan, and came to the following conclusions: at the first level of analysis (the production process), the majority of the differences in productivity can be attributed to the way in which functions and tasks are organized (innovations in the design of manufactures and in the organization of the workplace) in each industry and in each country; traditional determining factors such as the degree of capital-intensiveness and the scale of the plant play a less important role. At the second level of causality, the authors establish a positive correlation between the level of productivity and the degree to which an industry is exposed to global competition (defined as above in the text). This reinforces the message of Porter's oft-quoted "diamond" (Porter, 1991), i.e., that the secret of competitive advantages lies in competition (first with domestic rivals and later with the best firms in the rest of the world).

### 3. Public policies

Clearly, had it not been for public policies compatible with the functioning of a global economy, this combination of technology and corporate organization would not have had the globalizing effects that can be seen today. What is more, the very processes of internationalization and opening-up of national economies –with the scale and characteristics that can be seen today– are in large part due to domestic policies which are compatible with the increase in cross-border flows.<sup>12</sup>

Examples of public policies which have clearly intensified trade flows over the last fifty years are the government agreements which led to the creation of the General Agreement on Tariffs and Trade (GATT) in 1947. At that time, customs tariffs on imported manufactures in industrialized countries were around 40%, which after several rounds of negotiations (including the Dillon, Kennedy and Tokyo rounds) was brought down to an average of 4% in the Uruguay Round. This and many other government initiatives, such as those relating to the creation of the United Nations and its various specialized agencies, come under the heading of national foreign policy and have given rise to the aforementioned concept of globalization, in the form of multilateralism.

At the same time, such foreign policies also created conditions which favoured the development of globalizing forces in the sense which most interests us here, since cross-border flows –which “multilateralism” undertook to promote– are the mechanism whereby transnational organizations can develop and apply their microeconomic strategies.

Meanwhile, a number of domestic market liberalization and deregulation policies –starting in the industrialized countries in the 1970s and subsequently adopted by many other countries around the world in the 1980s and the first half of the 1990s– created ideal conditions for the expansion and subsequent consolidation of the process of economic globalization as a microeconomic phenomenon.

<sup>12</sup> Even contraband activities –which should undoubtedly be classified as part of the process of internationalization of economic activities– reflect public policies. Thus, for example, adoption of a highly protectionist trade policy (with average import tariffs of, say, over 80%) will certainly be perceived as an incentive (indeed, an implicit subsidy) for smuggling.

These domestic policies were formulated, designed and implemented in the context of stabilization and adjustment programmes or liberalizing structural reforms, with the aim of raising the efficiency and flexibility of national economies and increasing their external competitiveness and productive capacity. Conspicuous examples of such policies are programmes of fiscal decentralization, financial deregulation, trade liberalization and privatization or disincorporation of public enterprises, together with the tax reforms which these programmes (especially foreign trade liberalization) naturally made necessary. The set of policies associated with such programmes is well-known under the name of the “Washington consensus”.<sup>13</sup>

The fact that a virtually identical set of domestic policies should have been adopted in many different countries almost simultaneously is unusual enough to warrant an explanation. It seems highly unlikely that such a sudden and massive conversion to a new form of “conventional wisdom” could be the result of completely independent national decisions.

Rather, an alternative explanation suggests itself: that national governments, caught between constant, cumulative internal pressures relating to income distribution which could not be accommodated by the now obsolete model of inward-oriented growth, together with more or less simultaneous external pressures, finally succumbed to the forces drawing them towards the new “conventional wisdom”. Thus they rallied to its cause and endorsed its pledges.<sup>14</sup>

The growing mobility of the capital –tangible and intangible, real and financial– controlled by transnational economic agents operating in increasingly “de-territorialized” fashion gradually translated into demands and promises –concrete or potential,

<sup>13</sup> The expression “universal convergence” has been suggested as an alternative to the controversial “Washington consensus”, coined by John Williamson. For the origin and evolution of this terminology see Williamson, 1993.

<sup>14</sup> Although the “World Bank version” of the causes of the “East Asian economic miracle” was not widely publicized until the appearance of its report *The East Asian Miracle: Economic Growth and Public Policy* (World Bank, 1993), it should be recalled that the programmes of stabilization and adjustment implemented in those countries that signed agreements with the IMF and the World Bank itself during the 1980s contained the basic elements of that “conventional wisdom” (accompanied by the famous conditionality clauses).

explicit or implicit, expressed by the markets or by the transnational corporate hierarchies themselves—which national governments were unable to withstand.<sup>15</sup>

All the foregoing leads to the conclusion that the causal thrust in the proposition under consideration—i.e., that globalization brings a loss of autonomy—ignores a number of important and complex interactions between the variable which is deemed to be the

determinant (globalization) and the sphere in which the loss of autonomy is deemed to occur (public policy). On the one hand, it ignores the important contribution made by foreign policy to multilateralism, which helped foster a globalized economy, and on the other hand it does not explicitly recognize that the implementation of important domestic policies is a rational adaptative response to external pressures connected with the process of globalization.

### III

#### The various possible forms of loss of autonomy

Autonomy, defined as the freedom to govern oneself or administer one's own affairs independently of outside influences, is a concept drawn from the political sphere. Thus, in order to discuss loss of autonomy in the economic sphere, we need to import and then adapt the concept to our own purposes in this essay.

This is not without risks and complexities. In the first place, the very essence of political processes is negotiation. Thus, it is normally impossible to distinguish between concessions a national government makes as part of an agreement with opposition parties in order to gain some tactical or strategic advantage (which are described as "skilful political negotiation") and concessions it makes as a result of external circumstances connected with the process of globalization (which are described as "a regrettable loss of autonomy"). Second, if political negotiation means making concessions in one area in order to gain advantages in another, higher-priority area, then the problem of loss of autonomy may simply be that it is the price

to be paid to achieve other aims. Lastly, it should be understood that this issue is not of a kind that lends itself to considerations of a cardinal nature. "Loss" of autonomy is an ordinal notion which leaves open spaces where indeterminacy and ambiguity reign.

At all events, the central governments of nation-States intervene in the economy with four general aims: i) to allocate resources for the provision of public goods; ii) to stabilize the course over time of macroeconomic variables such as production levels, employment, prices, the currency and public indebtedness; iii) to correct the distribution of income (personal, institutional or regional); and iv) to ensure an adequate and sustainable growth rate. To do this, they normally use three instruments: i) regulation (setting prices and public-sector charges, determining market entry and exit conditions, locating activities, ensuring compliance with standards of quality in production and marketing); ii) economic policy (policy on taxation, tariffs and public expenditure; monetary, credit, financial, exchange-rate, trade and industrial policy); and iii) direct participation as producing/distributing agents (public utilities) or financial backers (development banks).

Underlying these interventions there is always the assumption that the economic authorities are capable of setting objectives and outlining compatible goals, selecting and using efficient and effective instruments, minimizing the cost of their interventions and maintaining control of the constraints—political, economic and social—within which their policies operate. We will therefore speak

<sup>15</sup> The basic elements of this not-so-new "conventional wisdom" were established very early on by Harberger (1984) in a set of 13 rules for conducting economic policy (these were increased to 14 by Fischer, 1987). Little, Cooper, Corden and Rajapatirana (1994), for their part, put forward nine general guidelines to the same end. More recently, Harberger (1995) reexamined his recommendations, comparing them with Williamson's 10 points of convergence. Two important evaluations of the rise, development and subsequent decline of the new "conventional wisdom" can be found in Bierksterker (1995) and Krugman (1995).



of loss of autonomy by the national economic authorities whenever the process of globalization of the world economy has an adverse effect on the operation of this assumption.

This loss of autonomy may take various forms, of which the following are the most outstanding:

a) *Instrument-related*

- i) Loss of instruments.
- ii) Reduction in the efficiency or effectiveness of instruments.

b) *Constraint-related*

Increase in the number, complexity and strategic importance of the constraints within which the economic authorities have to work.

c) *Objective-related*

- i) Increase in the number and importance of the political objectives that cease to be viable options.
- ii) Increase in the cost of separating domestic policies from the markets and maintaining what the transnational corporate hierarchies regard as "fundamental" values.
- iii) Rise in standards for setting and achieving quantitative goals.

Based on this list, which is merely illustrative and far from exhaustive, let us now examine some examples drawn from monetary, banking, exchange-rate and fiscal policy.

## IV

### Banking and monetary authorities

Discussions of the process of de-territorialization of economic activities usually refer only to the activities of transnational companies operating in the real sphere of production, trade and direct investment in risk capital (cf. Dunning, 1993). However, the most obvious example of globalization is to be seen in the activities of commercial and investment banks, insurance companies and other agents in that field (including transnational corporations themselves, in their financial dealings with some of those institutions). Thus, the typical activities and operations of the financial markets are those which best fit the characteristics of figure 1, quadrant 2.<sup>16</sup>

Globalization of financial markets is the epitome of the synergistic interaction of technical progress, deregulatory policies and models of corporate organization. The spectacular advances in communications systems and in the technology of processing, storing and transmitting data and information have given rise to imaginative financial innovations characterized by sophisticated "products" and complex techniques of analysis and management. Likewise, the widespread financial deregulation—consisting basically of the

elimination of controls on cross-border capital movements and the abolition of ceilings on loan and deposit interest rates—has fostered greater internal competition, higher international mobility of short-term capital, and growing international financial integration.<sup>17</sup>

The figures cited by Baumann (1995), Griffith-Jones and Stallings (1995) and the IMF (1995) for the scale and rate of variation of some international flows, both in the real sector and in the financial sector, clearly show that the traditional quantitative relationship between the two sectors is very much out of balance. Indeed, it could be said that financial flows have acquired a life of their own, crossing borders back and forth many times a day in a flurry of speculation, quite independently of the real economic base to which until recently it was assumed they were tied. The growing mobility and dematerializa-

<sup>16</sup> The possibility of links between transnational corporations and banks depends on the model of corporate control and financial intermediation in use in each country. For a recent analysis of the advantages and limitations of the basic models (American, German and Japanese), see Porter (1992), Gray (1994) and Prowse (1994).

<sup>17</sup> The origin of the current globalization of financial markets can be found in the rise of the Eurodollar market at the end of the 1940s, when the former Soviet Union placed its dollar holdings in French banks in order to forestall the eventuality of the United States freezing its accounts. When the United States imposed controls on capital in the 1960s, American banks and companies "discovered" the Eurodollar market, which they used as a source of funds to circumvent the exchange controls and thus finance their operations. The end of the Bretton Woods system in 1971 and the recycling of petrodollars which began in 1973 gave a new dimension to this market, which was finally "globalized" when deregulation of financial markets began in industrialized countries during the 1970s.

tion of money—which has now been reduced to pure electronic information transmitted across cyberspace instantaneously and simultaneously through networks of computers—has transformed the activities of the financial markets into a prime illustration of the de-territorialization characteristic of the globalization process.<sup>18</sup>

As can easily be imagined, this new situation creates enormous challenges for Central Bank authorities and for others who are responsible for the implementation of banking, monetary and exchange-rate policies.

In the first place, the extraordinary growth of the interdependencies between financial institutions—both domestic and foreign—made possible by the deregulation and innovation that accompany the globalization process increases the system risk. The origins of such risk are invariably to be found at the microeconomic level, in the possibility that a financial institution may be unable to meet its obligations. This could drag others along in a chain reaction towards insolvency, and even possibly lead to the breakdown of the whole system. After the Barings Bank episode, it is easy to see that an increase in external exposure means an effective reduction in the efficiency and effectiveness of the instruments of banking supervision.

The financial system's greatest vulnerability stems from:

i) the growing lack of transparency of institutions' statements and balance-sheets, due to the intensive use of derivative products and other instruments of extreme technical complexity, with associated risks which are very difficult to estimate;<sup>19</sup>

<sup>18</sup> O'Brien (1992) coined the expression "the end of geography" (possibly by analogy with Fukuyama's "the end of history") as a metaphor for the idea of the de-territorialization of a large part of contemporary financial operations. Such operations take place, as my colleague Edgardo Noya puts it, in "Borgesian space", where the infinite and the simultaneous unite in the twinkling of an eye.

<sup>19</sup> On the lack of transparency in financial institutions' statements and balance-sheets, the current President of the European Monetary Institute (formerly General Manager of the Bank for International Settlements) stated recently: "Not to put too fine a point on it, I would defy even a professional in financial matters to take the published accounts of a major international bank or other financial institution and come up with an accurate assessment of that institution's affairs. This lack of transparency not only invalidates one of the key assumptions needed for the free economy to produce an optimal allocation of resources, but it also means that participants may not be in a position to apply to financial institutions the de facto market discipline required to prevent the risk of systemic problems." (Lamfalussy, 1995).

ii) the increasing fragility of the inter-bank payments system, which has become the weakest link in the chain of institutional arrangements designed to avoid systemic crisis, as a result of the rocketing value of the payments made through these mechanisms as compared to the average net resources available to the participants in the system; this means that any failure of synchronization—because of one agent's lack of liquidity—could spark off a major systemic crisis;<sup>20</sup>

iii) the instability of the prices of financial assets, which translates into greater short-term volatility (in, for example, foreign currency markets) or, even more seriously, into misaligned medium-term prices (as, for example, in foreign-exchange, property and bond markets during much of the 1980s in some industrialized countries). Clearly, when these bubbles burst, the system risk increases.

The increase in system risk which results from the globalization of financial markets translates into potential adverse effects on the management of monetary and fiscal policy. In the monetary sphere, an injection of credit to revive institutions that are "too big to bust" is a threat to trends in monetary aggregates and inflationary expectations. In the fiscal sphere, any systemic crisis may entail a large tax increase in order to restore macroeconomic equilibria.

Second, it is clear that, as domestic financial institutions become more vulnerable owing to the interdependencies associated with the globalization of the world financial system, national Central Bank authorities lose the incentive to control the rise of monetary aggregates in a manner consistent with bringing down the annual rate of inflation. Under these circumstances, the authorities' first priority will be to safeguard the integrity of the financial system, with anti-inflation policy taking second place.

<sup>20</sup> It is well known that when agents pull out of interbank payments systems because they anticipate problems in the way they function, this triggers a crisis of liquidity which could lead to a systemic crisis. This example of a self-fulfilling prophecy bears the name of "Herstatt risk", in memory of a German bank which foundered in 1974 for this reason. According to Crockett—the present General Manager of the Bank for International Settlements—it is estimated that in two and a half business days the interbank settlement systems of Switzerland and Japan generate a turnover equivalent to those countries' annual GDP. In the United States and Germany, the corresponding time is between three and four days (Crockett, 1994).

Third, the surge in financial innovations and in the volatility of the prices of assets such as foreign exchange, property, and stocks and bonds tends to undermine the stability of the relationship between the main monetary aggregates and GDP. Financial globalization thus renders monetary transmission mechanisms less and less predictable (which reduces the efficiency and effectiveness of monetary policy).

Fourth, the existence of currency markets around the world which operate 24 hours a day, with information provided through computers connected to a network, allows instant substitution of currencies in investors' portfolios. This phenomenon of monetary substitution between countries suggests it may be most efficient to control monetary expansion at the supranational level.<sup>21</sup>

Fifth, with sufficient international mobility of financial capital, a policy which sets the nominal exchange rate but does not restrict currency trading in any way makes the base monetary supply endogenous (i.e., there is a loss of autonomy in the management of monetary policy as an instrument to determine the level of activity and prices).

In other words, in an economy with globalized financial markets and highly mobile speculative capital, the economic authorities must choose between i) replacing the exchange-rate anchor by a monetary anchor, whatever the cost in terms of loss of control over the stock of public debt which may be caused by the rise in interest rates on public securities, a decline in private investment and in activity levels, and greater vulnerability of the banking system; or ii) maintaining the nominal exchange rate, whatever the cost in terms of exchange-rate slippage and consequent loss of tax revenue on foreign trade operations, in terms of a rise in the trade deficit, and in terms of fluctuations in the international reserves. Thus, the "impossible trinity" (fixed nominal exchange rate, movement of capital and monetary autonomy) may be seen as a sign that the domestic authorities have lost autonomy as a result of the financial globalization process.

Sixth, as the instability of European exchange rates has shown since the crisis of September 1992 –and as the recent Mexican and Argentine experiences also reminded us– global financial markets are

growing less and less tolerant of domestic policies which involve significant or permanent exchange-rate slippages. Since the Mexican crisis of December 1994, the behaviour of the markets has enormously reduced national economic authorities' leeway for using the nominal exchange rate as an anchor for the price system. The Mexican experience speaks volumes, for since then the country has had to accept a floating currency. The Argentine experience was based on a determination not to devalue; however, the recent announcement of an unemployment rate of 18.6% (national average) may be interpreted as an indicator of the political and social price that has to be paid for insisting on an autonomous course of action. The Brazilian experience illustrates an intermediate situation, in which it was necessary to alter the original design of the "Plan Real" –first by adopting a floating currency band and later adjusting the band in a manner consistent with devaluation– in order to satisfy market expectations.

Seventh, the discipline imposed by the functioning of global financial markets affects even the way quantitative targets are handled by the monetary authorities. Thus, for example, in an economy with annual rates of inflation and of growth in the monetary base equal to 50%, an announcement by the Central Bank that it intended to cut growth in high-powered money only to 48% per annum would probably be seen by the markets as a lack of political will to deal with the problem. On the other hand, if it were announced that primary money creation would not exceed 0% per annum, the markets probably would not take this announcement seriously (or would interpret it as consistent with plans for a price freeze).

Finally, in so far as the numerous creative innovations in the financial sphere allow private-sector agents to protect themselves against possible changes of course in monetary or exchange-rate policies, such policies tend to become less efficient. This is a variant of Goodhart's law, which in its original version stated that when economic agents discover the existence of a stable relationship (between two or more variables), the relationship breaks down (because it is then overexploited). In this case, when agents learn to use instruments arising from banking deregulation promoted by the Central Bank, the efficiency of the Bank's monetary policy tends to be neutralized (since the agents have an incentive to cover themselves against Central Bank initiatives through adroit use of those instruments).

<sup>21</sup> Lane and Poloz (1992) show that aggregate demand for money among the members of the Group of Seven tends to be more stable than the demand for each currency on its own.

# V

## Fiscal authorities

When seeking to illustrate the restrictive effect of trade liberalization on fiscal authorities' freedom of movement, the first case which comes to mind is the well-known example of the public expenditure multiplier. In the context of Keynesian policies, which aim to make up for lack of (or excess) demand in the private sector, trends in aggregate demand in a closed economy ( $D = Ad = Cd + Gd + Id$ ) can be stabilized by means of a compensatory variation in the level of public expenditure or taxation. However, as the economy internationalizes, aggregate demand becomes ever more sensitive to fluctuations in the determining factors of the trade balance ( $D = Ad + X = A + X - M = C + G + I + X - M$ ), causing the public expenditure multiplier to go down as a result of "leakages" originating in the demand for imports.

This well-known argument is the result of comparing the same economy in circumstances of autarchy and of openness, and it shows the degree of loss of freedom suffered by the central government of a nation-State when the domestic economy opens up to external trade.<sup>22</sup> However, this is not sufficient to demonstrate the effects of world economic globalization on the level of autonomy of national authorities in devising and implementing their own fiscal policy objectives. The reason, as mentioned above, is that globalization and liberalization are not synonymous.

The fiscal complexities that result from globalization are brought out when we look at the levels of taxes levied on transnational corporations' profits by rival tax authorities: the difficulties arise in respect of the allocation of the right to levy taxes among different nation-States where the companies operate or where the head office is situated.

The foregoing is related to the structural change that globalization provokes in the patterns of international trade and of foreign direct investment (figure 2).

<sup>22</sup> An estimate of this loss can be obtained by calculating the increase that would be required in the public sector deficit in order to reach a given degree of growth in the level of activity or employment, compared with that required in a situation of autarchy.

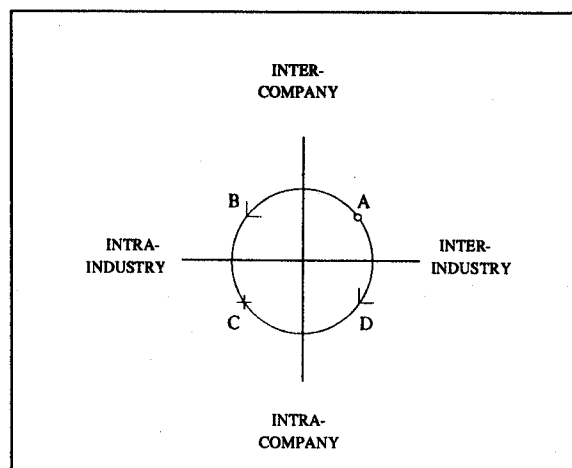
Area A corresponds to the foreign trade operations with which we are familiar from Heckscher-Ohlin's arguments. In this area, each country exports (imports) the good that makes intensive use of the production factor with which it is best (worst) endowed. This is the basis for the conventional notion that trade is carried out between unlinked enterprises (the "arm's length" principle) from two countries that buy and sell products from different industries (say, textiles from Britain and wine from Portugal). This traditional pattern of international trade between companies and between industries can be interpreted as typical of the primitive phase of internationalization of the world economy (although it may be noted that it still obtains for many products).

Area C corresponds to the most typical aspects of the current phase of globalization. The emphasis here is on intra-company and intra-industry trade and investment, carried out by transnational corporations which operate on the basis of global logic and use a flexible form of organization of the type described earlier.

The following is a list of some of the many problems that fiscal authorities must deal with as cross-border operations (trade, investment and finance) tend to concentrate in area C.

FIGURE 2

International trade and intra-company trade



Source: Prepared by the author.

First, the institutional arrangements for the control of cross-border flows –i.e., national customs services– are a legacy of the time when international economic relations were typical of area A. Thus they are basically designed to contend with traffic in merchandise susceptible of physical control (tons of meat or sugar, cases or hectolitres of wine, hundreds of tyres, thousands of trucks or cars), carried out by companies which are not linked with each other and therefore use market prices to determine credit and debit. The transactions which are typical of area C, however, involve trade flows which contain an increasing element of services, information and knowledge. It could be said, in a way, that flows are becoming more and more “conceptual”, and their increasingly intangible nature tends to make it difficult to assign to them the monetary values every country requires for tariff and taxation purposes in general.

Second –and this point is connected with the foregoing one– it happens that the agents involved in activities in area C tend to be members of transnational hierarchies for which the essential point of international trade is to move goods and services –including financial products and services– within their own organization. When this involves moving the goods and services between different countries, this is because such movements are in the organization’s interests and serve its global strategy better. It sometimes happens that the “transfer prices” used in internal buying and selling operations (between different subsidiaries and affiliates and the head office) facilitate well-known manoeuvres which may have by no means insignificant consequences for taxes and the exchange rate. This issue is of considerable importance to tax administrations and the Central Banks of countries such as Brazil: when dealing with trade in services (accounting, credit and finance, research and development, personnel training, etc.) and in other valuable intangibles (patents, formulas, processes, designs, copyright, trade marks or brand names, models, franchises, licences, technical data, customer lists, etc.) the fiscal authorities have to work hard if they are not to lose some degree of liberty –in the form of loss of tax revenue– because of the globalization process.

Third, it has to be borne in mind that there are incentives for transnational corporations to manipulate “transfer prices” not only to optimize their global taxation plans (by transferring profits from countries where the tax burden is high to others where it is

lower), but also –among other things– in order to repatriate profits over and above the levels permitted by local regulations, to reduce risks in exchange operations, to capitalize assets, to circumvent price controls, to respond to charges of dumping or other monopolistic activities, to neutralize wage demands, to subsidize an “infant” subsidiary, to penetrate new markets or to increase their share in traditional markets. Clearly, there are many ways in which economic globalization, in the form of transfer prices, can have an adverse effect on the interests of the national treasury.

Fourth, it is worth looking at the growing interaction between the financial side of national economies and dynamic international financial markets. In this context, it is evident that “global banks” –such as Chase Manhattan, Chemical Bank and others– represent a very particular form of transnational corporate hierarchy, from the standpoint of the type of “products” with which they work and the type of control to which they are subject in each country (usually through the Central Bank). At the same time, it is important not to lose sight of the fact that such banks –along with the other financial agents who carry out international financial operations– have the same incentives as transnational corporations on the real side of the economy (and possibly more facilities) to manipulate their own “transfer prices”. Given the enormous volumes handled by these institutions (in cross-border intra-company hedging, speculative and arbitrage operations), even small price spreads may represent huge losses for the fiscal authorities.

Fifth, the growing importance of transnational corporations is becoming more and more evident in the volume of foreign direct investment and trade they generate (area C in figure 2). It can be assumed that these activities have important counterparts on the financial side (such as the creation or destruction of financial holdings connected with export and import payments, hedging operations to reduce exchange-rate risk, foreign-exchange market operations to repatriate profits or capital, etc.). In view of the quantitative importance of these operations within total external operations, the average level of international reserves and the volume of operations in the foreign-exchange market, taken as a whole, it is clear that Central Banks need to keep a close watch on what transnational corporations may be doing (or may do in the future), in coordination with the “global banks”, with regard to transfer prices.

Sixth, there are various niches where there is strong interaction between the real side and the financial side of transnational corporations. For example, at any given moment transnational corporations have liquid assets and liabilities denominated in various currencies and located in many countries, and the movements of foreign exchange brought about by these companies' cash-flow management techniques thus involve enormous transfers even when small interest rate spreads apply, owing to their volume and the fact that they are carried out on a continuous basis. Another example of such niches is the so-called "captive insurance industry" –in other words, an insurance company that is a subsidiary of a transnational corporation in the non-financial sector (e.g., an automobile manufacturer) or is controlled by one. The motivation behind the creation of such "captive" insurance companies is evident from the fact that in 1991 75% of them were located in offshore tax havens. This and other patterns of operation in transnational corporations implies a further loss of autonomy for fiscal authorities.

Lastly, the tax burden of a transnational corporation in a country can also be altered by i) replacing trade flows with foreign direct investment flows (the profits from which tend to be exempt from tax for several years); ii) reorienting production towards the export of manufactures (allowing the mechanism for the refund of value-added tax to reduce the net contribution from its operations to the treasury); and iii) reorienting the composition of its exports towards services (which means that tax administrators will find it practically impossible to exert adequate fiscal control).

## VI

### Final remarks

The globalization of the world economy is an ongoing process whose long-term consequences in different areas can as yet only be partially glimpsed.

What is clear, however, is that this process poses extraordinary challenges to those responsible for the stability of the financial system and the implementation of monetary and exchange-rate policy. Similarly, tax administrators and those responsible for other areas of fiscal policy face increasing difficulties in devising and implementing policies which are ca-

The foregoing examples barely skim the surface of the many and complex ways in which the autonomy of national fiscal authorities can be diminished by the behaviour and strategies of the chief agents of the globalization process: i.e., transnational corporations on either the real or the financial side. There are of course many other channels which this essay does not touch on and which are not directly or necessarily connected with these economic agents.

As a brief illustration of this last point, let us return to the case of small economies which are open to short-term capital flows and which maintain a fixed nominal rate of exchange as part of an anti-inflation programme. Obviously, the disadvantage of easy access to external financing is the potential adverse effect of excessive money supply on inflation targets. The Central Bank is forced to intervene through sterilization operations, with a resulting increase in the supply of domestic bonds and a rise in interest rates.

The foregoing has at least two consequences: i) it reinforces the system of incentives that encourage a net inflow of capital (which leads us to expect that in the future, all else being equal, there will be further sterilization operations which will raise interest rates in order to ensure that the market continues absorbing more and more domestic securities); ii) it tends to make the public accounts more vulnerable, owing to the corresponding increase in public debt service. As Calvo (1991) anticipated, this combination of effects provokes a loss of confidence among economic agents in the sustainability of the anti-inflation programme, and the greater the net inflow of short-term capital, the more pronounced this effect.

pable of neutralizing the adverse effects of globalization on the autonomy of the economic authorities.

The globalization phenomenon effectively restricts national governments' freedom of movement. However, the disciplining force of international competition which underlies at least a large part of the process may have considerable beneficial effects on the future course of public policy in the countries of the region. Thus, when talking about "loss of autonomy", care must be taken to check whether it is not rather a matter of a

welcome "reduction in the level of arbitrariness" with which public policy is sometimes applied. It is worth asking, for example, whether the international financial markets' growing intolerance –of arbitrary manipulation of the exchange rate, or of sustained high public deficits– really affects domestic authorities' autonomy (by tightening the restrictions on governments) or if it is not rather a force for good which will prevent greater evils in the future (such as the accumulation of large exchange rate slippages which give rise to financial traumas with considerable negative effects in the real sphere of the economy when devaluation inevitably occurs).

Be that as it may, the nation-State as we know it is going to remain for a long time yet the basic organizational unit of the political, economic, social and cultural life of our peoples.<sup>23</sup> Globalization presents it with new, complex challenges, but also great opportunities. National economic authorities have at their disposal powerful instruments to help them meet these

challenges, and they must work up a level of enthusiasm to match in order to make the enormous effort needed to take advantage of the opportunities thus presented. Among the many options open to national governments –which for reasons of space are not dealt with here– one which should be borne in mind is the ECLAC (1994) proposal on open regionalism. As Stallings (1995) shows, national governments are already making significant regional responses to these global challenges. The question is to determine which of the broad integration schemes through which these responses are being channelled –i.e., those in the tradition of the Treaty of Rome (where the leadership is exercised by government hierarchies, as in MERCOSUR), or those along the lines of the Chinese experience (where leadership is exercised by private agents through the markets)– is least damaging to the future autonomy of the nation-State.<sup>24</sup>

(Original: Spanish)

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<sup>23</sup> One of the most fervent exponents of the thesis of the nation-State's obsolescence and the rise of the region-State is Ohmac (1993, 1995).

<sup>24</sup> For details of the Chinese experience, see Jones, King and Klein, 1992.

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