Globalization and Liberalization: The Impact on Developing Countries

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Santiago, Chile, December 2001
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Summary

This paper analyzes the impact of globalization on developing countries over the last several decades. The first section examines the components and mechanisms of globalization. The second turns to financial globalization—considered to be the most important aspect of a multifaceted process—and looks in more detail at the changing trends in finance for developing countries. The third analyzes the impact of the new pattern of finance in terms of growth, equity, and government autonomy. The concluding section offers policy recommendations for making globalization a more positive force.

Four basic arguments are developed in the paper with respect to the impact of financial globalization. First, globalization has increased the capital available to developing countries, which potentially increases their ability to grow faster than if they had to rely exclusively on their own resources. Not all capital flows contribute equally to growth, however; short-term flows and the purchase of existing assets are less valuable than investment in new facilities. At the same time, the increasing mobility of capital can also lead to greater volatility, which is very costly for growth. Second, capital flows are unequally distributed by region and country, thus skewing the patterns of growth. There is also an unequal distribution of capital within countries by geographic area, sector, type of firm, and social group, creating a division between winners and losers. Third, government attempts to extract the benefits from the globalization of capital, while limiting the costs, is more possible than usually thought. The source of many problems is local rather than global, and the experience of several countries indicates that “heterodox” policies can be followed. Finally, policy changes at the global, regional, and national levels could improve the picture just sketched out.
Introduction

Globalization is one of the most controversial topics of the early twenty-first century. Academic debates currently raging about globalization include whether it even exists (Unger, 1997), whether it is more important now than at some earlier date (Bordo, Eichengreen, and Irwin, 1999), whether it is displacing the nation state (Strange, 1996; Wade, 1996), and whether it is more important than regionalism (Fishlow and Haggard, 1992; Oman, 1994) or localism (Rosenau, 1997a). Also, of course, there are extensive analyses as well as polemics about whether the results are good or bad and for whom (see especially Rodrik, 1997 and 1999). Recently, such controversies have spilled over from academic journals to street demonstrations in locations as diverse as Seattle, Washington, Montreal and Genoa.

This paper takes for granted that globalization exists and that it is a very important phenomenon without entering into the various comparisons with the past or other parallel processes. The main objective is to analyze the impact of globalization over the past several decades, particularly in terms of its effects on developing countries. To what extent has globalization constrained decision making in developing countries, and how has it affected the potential for growth and equity. While the focus is on the globalization of finance – arguably the most important aspect of the multifaceted process – we first take a broader look at the globalization phenomenon. This is followed by data on new trends in finance for developing countries, an

1 The author wishes to acknowledge helpful comments from the participants in a United Nations University seminar held in New York in December 1999 as well as those at the Secretary of State’s Roundtable, held at the Institute for Development Studies, University of Sussex, in July 2000, as part of the preparation for the U.K. White Paper on Globalization and Development. The assistance of Guillermo Mundt with the statistical data is also appreciated.

2 For an excellent analysis that does address comparative issues, see Held et al (1999).
analysis of the impact of the new pattern of financial flows, and some conclusions with respect to policy recommendations.

Four basic arguments are developed in the paper with respect to the impact of financial globalization. First, globalization has increased the capital available to developing countries, which potentially increases their ability to grow faster than if they had to rely exclusively on their own resources. Not all capital flows contribute equally to growth, however; short-term flows and the purchase of existing assets are less valuable than investment in new facilities. At the same time, the increasing mobility of capital can also lead to greater volatility, which is very costly for growth. Second, capital flows are unequally distributed by region and country, thus skewing the patterns of growth. There is also an unequal distribution of capital within countries by geographic area, sector, type of firm, and social group, creating a division between winners and losers. Third, government attempts to extract the benefits from the globalization of capital, while limiting the costs, is more possible than usually thought. The source of many problems is local rather than global, and the experience of several countries indicates that “heterodox” policies can be followed. Finally, policy changes at the global, regional, and national levels could improve the picture just sketched out.
I. Components and Mechanisms of Globalization

There is no generally accepted definition of globalization; most attempts concentrate on the economic components. An exception is that of James Rosenau, who says: “Globalization [is] a label that is presently in vogue to account for peoples, activities, norms, ideas, goods, services, and currencies that are decreasingly confined to a particular geographic space and its local and established practices” (Rosenau, 1997b, p. 360). From this vast array, four separable, but interrelated, sets of issues are especially relevant: (a) macroeconomics (trade and finance), (b) microeconomics (the technological revolution and the production process), (c) culture and the media, and (d) pressures for democracy and human rights. We will briefly comment on the most important aspects of each, always with a focus on their implications for developing countries.

The macroeconomic components of globalization are perhaps the best known. Thus, the dramatic increase in the value of international trade, and the fact that trade has grown much faster than production in the postwar period, are frequently cited as evidence of globalization. The World Trade Organization (WTO) reports that world merchandise exports in 1948 totaled $58 billion, while in 1997 the figure had ballooned to $5,300 billion. In 1990 dollars, the figures were $304 billion and $5,223 billion, respectively. Trade in services was growing at an even faster rate, such that the combined exports of goods and services rose from 8 percent of world GDP in 1950 to 26 percent in 1997 (WTO, 1998, p. 120). Data on capital flows do not go back as far, but the growth rates in the past two decades have
outstripped those of trade. Private capital flows rose from an average of $107 billion in the 1980-82 period to $1,300 billion in 1996-98 (IMF, *Balance of Payments Yearbook*, various issues).

Developing countries as a group, including the former communist countries of Central and Eastern Europe, have become more integrated into these economic flows in the past twenty years. Table 1 provides a rough idea of the changes. In terms of world imports, developing countries’ share fell during the 1980s (from 30 to 25 percent) and then jumped to 34 percent by the late 1990s. A similar situation was found with exports from developing countries to the world although the trend was more muted. In both cases, however, the changing importance of trade in oil masks the degree of increasing integration. Another way of thinking about the rising importance of trade is to look at the change in export and import coefficients (i.e., trade as a share of countries’ own output). By this measure, too, international integration has increased as coefficients for developing countries followed a pattern similar to that just seen: a decline from 24 percent in 1980 to 22 percent in 1990, then an increase to 28 percent in 1997 (calculated from World Bank, 1999).

Financial trends were more dramatic than those for trade, declining more abruptly in the 1980s and rising faster in the 1990s. For example, the developing country share of foreign direct investment (FDI) plummeted from 33 percent in 1980-82, before the debt crisis hit, to only 14 percent by the end of the decade. It then more than recovered to 43 percent by 1996-98. Portfolio trends were similar but the numbers were much smaller: 8 percent, 3 percent, and 13 percent, respectively. While the private flows shown in table 1 increasingly dominate total flows, official loans (both bilateral and multilateral) remain important in two ways: they are the main type of international financing available to poor countries, and the conditionality that accompanies them is an important channel for promoting particular types of economic policies.

The microeconomics of globalization has to do with the technological revolution, which is reflected in the increasing dominance of transnational corporations (TNCs) with their privileged access to the latest advances in new technologies. Whether these be in transportation, communications, electronics, robotization of production lines, or “soft” areas such as “just in time” management techniques, the developments of the past few decades have enabled TNCs to increase their share of global output and trade. Despite the difficulties in measuring such trends, UNCTAD estimates that the sales of foreign affiliates of TNCs increased from around 10-15 percent of world GDP in the early 1970s to around 25 percent in the late 1990s. Likewise, World Bank data suggest that overseas affiliates’ output as a share of world private GDP rose from 8 percent in 1982 to 11 percent in 1995 (Held et al, 1999, p. 246).

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3 As oil prices rose and then fell, this had a strong impact on trade patterns, especially with respect to the Middle East. The value of that region's trade was very high in 1980 and then fell steadily through the end of the 1990s. Thus, excluding the Middle East from the calculations in table 1 would show a larger increase in developing countries’ share of world trade.

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<table>
<thead>
<tr>
<th>Table 1</th>
<th>THE ROLE OF DEVELOPING COUNTRIES IN WORLD TRADE AND CAPITAL FLOWS, 1980-98</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports (%)</td>
<td>34.3</td>
</tr>
<tr>
<td>Imports (%)</td>
<td>31.9</td>
</tr>
<tr>
<td>Totala (billions of $)</td>
<td>1,890</td>
</tr>
<tr>
<td>Direct Investment (%)</td>
<td>32.7</td>
</tr>
<tr>
<td>Portfolio Investment (%)</td>
<td>7.7</td>
</tr>
<tr>
<td>Totala (billions of $)</td>
<td>107</td>
</tr>
</tbody>
</table>


a Total for developing and industrial countries.
The increased role of TNCs is significant but not overwhelming in quantitative terms; to fully appreciate the phenomenon it is necessary to take account of qualitative shifts as well. In particular, the globalization of production has resulted in new ways for TNCs to expand their networks to take advantage of the lowest costs and greatest flexibility. Indeed, many of the new forms of “value chains” do not involve overseas investment at all, but rather buying agreements with foreign producers whereby the TNCs specify the characteristics of goods and the time schedule for subcontractors in many parts of the developing world. Services, ranging from billing to accounting to online support, are also increasingly outsourced to developing countries. If they are to participate in these new types of investment, as well as the more traditional types, developing countries must be ready and able to meet the requirements of investors (Gereffi, 1995).

The globalization of culture and the media has been strongly stimulated by the expansion of TNCs in general and the communications revolution in particular (Herman and McChesney, 1997; OECD, 1997). The same products have become available throughout the world, whether they be food, clothing, music, or television programs. In the cultural realm, these trends have fostered the identification of the middle classes – and increasingly the lower classes – in developing countries with their counterparts in the United States, Europe, and Japan. Policies that might limit access to desired goods and services, including travel, have thus become increasingly difficult to carry out. On a more directly political level, the growing presence of Western-educated leaders (both politicians and technocrats) who espouse economic policies in vogue in the industrial countries limits the range of policy options that are considered legitimate in developing countries. This trend is complemented by global sources of news, first through the cable channels and more recently through the internet (Held et al, 1999, chp. 7).

Finally, and closely related to the cultural channels above, it is not only economic policies that have spread throughout the globe, but also political values and institutions. Under certain conditions, the multilateral institutions have begun to include political as well as economic conditions as the counterpart to their loans; these typically involve a minimal recognition of human rights and democratic forms of governance (Nelson and Eglinton, 1993; Gwin and Nelson, 1997). More direct have been bilateral and regional demands for democracy and human rights, both as a condition for loans, but also for membership in regional organizations. Thus, the democratic clause in the European Union charter is an important influence on potential members, while in the Western Hemisphere the Organization of American States and Mercosur (Southern Common Market) have similar requirements. Even Japan, initially reluctant to intervene in the internal affairs of its neighbors, has begun to include political criteria on its large-scale economic aid packages (Stallings and Sakurai, 1993; Fawcett and Hurrell, 1995).

How have these various types of globalization been propagated? The most important way is by spontaneous, market-based mechanisms whereby corporations and other economic actors engage in their own preferred activities and, in the process, create links between groups, nations, and regions. The microeconomic and cultural elements of globalization are clear examples of this type of process as are the financial aspects of the macroeconomic link. The globalization of trade, by contrast, is an example of a second kind of mechanism, which is based on planning and negotiation. It has thus been closely related to the activities of the WTO (formerly the GATT), which is one of the main institutions that promotes globalization. The move toward greater support for democracy and human rights has also been negotiated, in this case through the Development Assistance Committee of the OECD and the regional integration institutions. Finally, there have been attempts, not very successful up till now, to negotiate rules for capital flows through the IMF and World Bank. It is important to note that while these organizations have a strong impact on the behavior and performance of the developing countries, the latter are generally not well represented in the decision making bodies of the organizations. Thus the legitimacy of their decisions can be called into question.
A final distinction needs to be drawn between globalization and liberalization. Developing countries themselves had to take some important steps before the full impact of globalization could be felt. Specifically, they had to open their economies, to lower the barriers to trade and capital flows that had been an essential component of the import-substitution industrialization model that almost all followed for some period. Without these policy shifts, globalization would be much less relevant than it is today, especially in the developing world. Liberalization, then, is the other side of globalization.

At the same time, liberalization is also a creature of globalization. Looking back to the four aspects of globalization discussed above, several linkages stand out as helping to promote liberalization in developing countries. One was the need to open economies as a prerequisite of membership in the GATT/WTO or as part of the conditionally accompanying loans from the IMF or World Bank. Also important was the increased cultural homogeneity of the world that stimulated demands for imports and travel on the part of local populations in developing countries. Finally, a key mechanism was the fact that many political leaders in developing counties came to agree with the types of policies that were advocated by the international financial institutions and private sector investors. As the Cold War ended, the influence of alternative ideologies waned, and democratic elections frequently returned leaders who favored such policies.
II. Developing Countries in a World of Globalized Finance

Of all of the economic trends involved in globalization, the globalization of finance has been the most dynamic. It has also had the strongest impact on the behavior and performance of developing countries. Thus, we will concentrate on this topic in the rest of the paper and look in more detail at the changes that have come about in the postwar period, especially in the last decade, and at their impact.

The total volume of capital flows increased substantially during the period. According to the World Bank, total net long-term resource flows to all developing countries (including Eastern Europe and Central Asia) rose from $11 billion in 1970 to $83 billion in 1980. The flows stagnated or declined for many (but not all) developing regions in the 1980s, then surged again during the 1990s. They increased from $98 billion in 1990 to $344 billion in 1997, before falling off to $318 billion in 1998 and $291 billion in 1999 as a result of the Asian crisis. Trends in net transfers (which subtract interest payments and profit remittances from net flows) were even more dramatic (see table 2).

Short-term flows, frequently referred to as “hot money,” are not included in table 2. Since these flows have become the most controversial type of foreign capital in the 1990s, it is important to try to get some idea of their magnitude and their volatility. One of the controversies includes the very definition of short-term flows. The World Bank limits its definition to short-term bank credits (less than one year). The Bank for International Settlements (BIS) also focuses on bank credit, but it includes all loans with less than a year to maturity, whereas the World Bank includes only loans with an original
maturity of less than a year. UNCTAD adds another variant since it defines short-term flows to include much of the portfolio investment category. Despite these differences, there is general agreement that short-term capital has become more prevalent and that it is highly volatile (BIS, 1999, pp. 146-50; UNCTAD, 1999, pp. 112-15; World Bank, 2000, chp. 4).

Table 2

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Net resource flows</td>
<td>11</td>
<td>75</td>
<td>99</td>
<td>340</td>
<td>334</td>
<td>265</td>
<td>295</td>
</tr>
<tr>
<td>Long-term debt flows</td>
<td>7</td>
<td>57</td>
<td>43</td>
<td>110</td>
<td>114</td>
<td>16</td>
<td>39</td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>2</td>
<td>4</td>
<td>24</td>
<td>173</td>
<td>177</td>
<td>185</td>
<td>178</td>
</tr>
<tr>
<td>Portfolio equity flows</td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>30</td>
<td>16</td>
<td>34</td>
<td>48</td>
</tr>
<tr>
<td>Grants</td>
<td>2</td>
<td>13</td>
<td>28</td>
<td>26</td>
<td>27</td>
<td>29</td>
<td>30</td>
</tr>
<tr>
<td>Net transfers</td>
<td>3</td>
<td>20</td>
<td>27</td>
<td>221</td>
<td>204</td>
<td>125</td>
<td>136</td>
</tr>
<tr>
<td>Interest on long-term debt</td>
<td>2</td>
<td>32</td>
<td>55</td>
<td>87</td>
<td>95</td>
<td>100</td>
<td>108</td>
</tr>
<tr>
<td>Profit remittance on FDI</td>
<td>5</td>
<td>23</td>
<td>18</td>
<td>32</td>
<td>35</td>
<td>40</td>
<td>50</td>
</tr>
</tbody>
</table>


*Excludes IMF loans.

Drawing on the minimalist definition of the World Bank, table 3 shows the trends in short-versus long-term finance during the 1990s. Short-term flows built up through 1996, fell sharply in 1997 and then became negative in 1998-99 before a small recovery in 2000. Long-term flows showed a similar pattern, but the year-on-year changes were more gradual and the net flows remained positive. The broader UNCTAD data, which go only through 1997, show a negative net short-term flow for 1997 and, presumably, a larger negative flow in 1998-99. The BIS shows a positive figure for 1997 ($43.5 billion) and a negative one ($85.0 billion) for 1998.

Table 3

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net long-term flows</td>
<td>123</td>
<td>156</td>
<td>311</td>
<td>343</td>
<td>335</td>
<td>265</td>
<td>296</td>
</tr>
<tr>
<td>Net short-term flows</td>
<td>20</td>
<td>38</td>
<td>43</td>
<td>16</td>
<td>-51</td>
<td>-18</td>
<td>4</td>
</tr>
<tr>
<td>Total net flows</td>
<td>143</td>
<td>194</td>
<td>354</td>
<td>359</td>
<td>284</td>
<td>246</td>
<td>299</td>
</tr>
<tr>
<td>Capital outflows plus</td>
<td>-17</td>
<td>-93</td>
<td>-150</td>
<td>-228</td>
<td>-189</td>
<td>-247</td>
<td>-307</td>
</tr>
<tr>
<td>errors and omissions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net external finance</td>
<td>126</td>
<td>101</td>
<td>204</td>
<td>130</td>
<td>95</td>
<td>-1</td>
<td>-7</td>
</tr>
</tbody>
</table>


*Excludes IMF loans.

Together with changes in the volume of external finance, the composition also shifted in important ways in the last two decades. The most important change was the increased role of private finance in comparison to public funds. Overall, the former rose much more than the latter, although there were some indications of a tradeoff as public funds came in when private finance fell off. Among sources of private finance, the commercial bank creditors, which in 1980 had been responsible for nearly 90 percent of all private finance and over half of long-term debt flows, had almost disappeared from the scene by the early 1990s. Moreover, debt flows themselves had become less significant, as foreign direct investment (FDI) had come to represent about one quarter of net resource flows, and official flows (including grants) had again risen as a share of the total.

During the course of the 1990s, the composition shift continued. The most dramatic element was foreign direct investment, which represented 48 percent of total private flows in 1997 and 80 percent in 1999. FDI had been considered the least desirable kind of foreign capital in the 1970s because of its
negative impact on the balance of payments and the restrictions it placed on internal decision making in developing countries. This was one reason for the shift toward bank loans. Now, as a reflection of the change in economic model, FDI is considered the most valuable kind of foreign capital, since it is not only more stable than other flows but also brings access to markets and technology. Much more unstable are portfolio equity investment, bonds, and bank loans, together with short-term flows as discussed above.\(^4\) Table 4 shows these changes in the context of the earlier postwar period.

### Table 4

**COMPOSITION OF LONG-TERM FINANCE TO DEVELOPING COUNTRIES, 1970-2000**

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Official flows</td>
<td>5.4</td>
<td>33.9</td>
<td>55.7</td>
<td>40.5</td>
<td>45.7</td>
<td>37.6</td>
</tr>
<tr>
<td>Multilateral loans(^a)</td>
<td>0.8</td>
<td>7.7</td>
<td>15.0</td>
<td>21.2</td>
<td>18.9</td>
<td>10.4</td>
</tr>
<tr>
<td>Bilateral loans</td>
<td>2.6</td>
<td>13.1</td>
<td>12.4</td>
<td>-6.8</td>
<td>-2.0</td>
<td>-2.4</td>
</tr>
<tr>
<td>Grants</td>
<td>2.0</td>
<td>13.1</td>
<td>28.2</td>
<td>26.1</td>
<td>28.8</td>
<td>29.6</td>
</tr>
<tr>
<td>Private flows</td>
<td>5.5</td>
<td>40.7</td>
<td>43.6</td>
<td>299.8</td>
<td>219.2</td>
<td>257.2</td>
</tr>
<tr>
<td>International capital markets</td>
<td>3.6</td>
<td>36.3</td>
<td>19.4</td>
<td>127.2</td>
<td>33.7</td>
<td>79.2</td>
</tr>
<tr>
<td>Debt flows</td>
<td>3.6</td>
<td>36.3</td>
<td>15.6</td>
<td>97.0</td>
<td>-0.7</td>
<td>31.3</td>
</tr>
<tr>
<td>Bank loans</td>
<td>2.4</td>
<td>28.9</td>
<td>3.2</td>
<td>45.2</td>
<td>-24.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Bonds</td>
<td>0.0</td>
<td>1.1</td>
<td>1.2</td>
<td>49.0</td>
<td>25.4</td>
<td>30.3</td>
</tr>
<tr>
<td>Other</td>
<td>1.2</td>
<td>6.3</td>
<td>11.3</td>
<td>2.7</td>
<td>-1.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Equity purchases</td>
<td>0.0</td>
<td>0.0</td>
<td>3.7</td>
<td>30.2</td>
<td>34.5</td>
<td>47.9</td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td>1.9</td>
<td>4.4</td>
<td>24.3</td>
<td>172.6</td>
<td>185.4</td>
<td>178.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10.8</strong></td>
<td><strong>74.5</strong></td>
<td><strong>99.3</strong></td>
<td><strong>340.3</strong></td>
<td><strong>264.9</strong></td>
<td><strong>294.8</strong></td>
</tr>
</tbody>
</table>

**Source:** Calculated from World Bank, *Global Development Finance, 2001*, CD Rom version.

\(^{a}\) Excludes IMF loans.

Closely related to the shift in composition of capital flows was the change in borrowers within the developing countries. In the 1970s and the 1980s, borrowers had mainly been central governments and state-owned enterprises. In the 1990s, by contrast, borrowers were increasingly large private-sector firms. FDI was, (almost) by definition, an element of the private sector.\(^5\) In addition, the share of private non-guaranteed debt flows increased from 15 percent in 1980 to 22 percent in 1990 to 60 percent in 1997 before falling to 40 percent in 1998 and 24 percent in 1999. (Part of the sharp decline appears to have had as a counterpart the expansion of private debt with government guarantees.)

Finally, there were important changes in the allocation of capital flows among developing country regions. During the 1980s, Latin America in particular had been starved for funds from the private sector, leading to an increased role for the multilateral agencies. East and Southeast Asia, by contrast, continued to have access to private funds. In the 1990s, Latin America regained access to private finance and Eastern Europe also became an active borrower, sharing the expanding pie with East/Southeast Asia. Sub-Saharan Africa continued to draw primarily on official sources, while South Asia and the Middle East had limited access to external finance of any type (see table 5).

After the international financial crisis that began in Asia in 1997, some changes occurred in the pattern just described. The most important was the decline in capital flows to Asia in 1998-99, which was both cause and effect of the crisis. Latin America and Eastern Europe held their own or increased their access to funds in 1998, but saw these flows drop off in 1999. The other three regions, which had been less privileged by foreign capital in the past, were correspondingly less affected by the crisis. Indeed, the Middle East appears to have been a beneficiary.

\(^{4}\) While long-term bonds would also appear to be a stable form of finance, they were increasingly issued with options that allow a lender to pull out before the official maturity date; see Griffith-Jones (1998).

\(^{5}\) The possible exception is the purchase of former state-owned enterprises in developing countries by state firms in Europe or the remaining socialist countries, especially China.
### Table 5

**REGIONAL PATTERNS OF LONG-TERM CAPITAL FLOWS TO DEVELOPING COUNTRIES, 1970-2000**

<table>
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**Source:** Calculated from World Bank, *Global Development Finance, 2001*, CD Rom version.

<sup>a</sup> Excludes IMF loans. <sup>b</sup> Portfolio investment, bonds, bank loans, and “other” flows.
Other insights about the nature of globalization can be obtained by noting with whom
developing countries trade and from where investment comes. Based on data for the first half of the
1990s, a clear distinction can be made (Stallings and Streeck, 1995). Asian developing countries
mainly traded among themselves and with Japan, and a growing share of their investment also came
from within the region. In Latin America, in contrast, trade and investment were heavily weighted
toward the United States, especially in the northern tier of countries. In Africa and Eastern Europe,
economic transactions focused on Western Europe.

What we referred to as the “tetrahedron” meant that different developing regions were tied
into the global economy in different ways through their main trading and investment partners.
Since the respective industrial countries featured different “models” of capitalism, this led to
somewhat different policies in the developing countries themselves. Growth rates of the industrial
countries also differed. In the 1980s and early 1990s, these differences contributed to the great
economic dynamism in the Asian region, but the decline of the Japanese economy exacerbated the
later problems of its Asian neighbors, and the high level of interaction within the region propelled
the contagion effect once the crisis there began in 1997. The lagging U.S. economy, which had
appeared to be a drag on Latin America in the 1980s and early 1990s, proved a boon to its
neighbors, particularly Mexico and Central America, later in the decade. In the early years of the
new decade, however, the simultaneous downturn in the United States, Europe, and Japan has had a
negative impact throughout the developing world.
III. The Impact of the New Pattern of Financial Flows

The main thrust of this section is on how the globalization of capital has affected growth rates and equity. In addition, we want to ask whether — and, if so, how — global finance has limited the autonomy of governmental decision making with respect to these two topics. It should be emphasized that these questions are extremely difficult to answer. Many other events and processes were occurring simultaneously, including other aspects of globalization, and it is impossible to separate the individual contribution of each. Nonetheless, we can draw some tentative conclusions with the help of comparative regional experiences and secondary analysis by other authors.

A. Capital flows and growth

At the aggregate level, growth is related to capital flows in two main ways. One involves the impact on investment, the crucial determinant of growth in the medium and long run. In the short run, of course, higher growth can result from fuller use of existing capacity. The other main link between growth and capital flows centers on cycles and sustainability. If capital flows are extremely volatile, they can stimulate growth in the short run, but such growth will be offset by recessions due in part to capital flight. Capital flows also make it more difficult for governments to carry out stable macroeconomic policies, which in turn contributes to the volatility of growth.
The foreign capital-investment relation has two components as reflected in the classic “two-gap” model. The first gap has to do with the lack of adequate savings in developing countries to finance the investment required to attain a desired growth rate. This situation can arise either through large fiscal deficits, which absorb available credit and thus “crowd out” the private sector, and/or insufficient savings by households and corporations. Under these circumstances, foreign savings (capital) can help fill the gap although evidence suggests that foreign savings is partially a substitute for domestic savings rather than being totally complementary. The parameters may vary between countries and regions; in Latin America in recent years, approximately 50 percent of foreign savings was offset by lower domestic savings (ECLAC, 2000a).

The second gap involves lack of foreign exchange. Even where there is adequate domestic savings, much of the machinery and equipment needed for investment in developing countries comes from abroad and must be paid for in foreign currency (usually dollars). The foreign exchange can come from a trade surplus, but if exports are insufficient then foreign capital is necessary. Foreign capital can also serve to extend the maturity structure of domestic savings, since local capital markets frequently lack a long-term segment.

The sustainability of growth is also related to capital flows. Insofar as capital flows are necessary for investment in developing countries, this implies a long-term stable type of flow to enable investment projects to be designed, implemented, and put into production. If the flows come in only for a short period of time (for example, to take advantage of interest rate or exchange rate imbalances), then they are not very useful from the investment perspective. The same is true if they are likely to leave as soon as any negative indicators appear in the domestic or international environments.

One mechanism through which capital inflows and outflows create volatility in the “real” economy (i.e., income and employment) is by shifting the capacity of local firms to import. With more capital inflows, they can operate at a higher capacity level, but when capital leaves they have to cut back. Another mechanism involves the impact of capital flows on macroeconomic policies of developing country governments. One sequence of events, which was more common in the 1970s than the 1990s, is for foreign capital to finance government budget deficits. Thus, if the capital pulls out, the deficits must be rapidly cut, leading to a fall in growth rates. A more recent problem is that capital inflows can lead to the overvaluation of the exchange rates and thus to large current account deficits that require measures to cool down the economy. Large inflows can also expand the money supply unless they are “sterilized,” which creates additional problems for central banks.6

As it happens, there is a link between the impact of capital flows on investment, on the one hand, and sustainability, on the other. It has to do with the composition of flows. Although there is some disagreement on this topic, most experts agree that foreign direct investment is more stable than other types of capital flows.7 Moreover, a substantial share goes directly to increase domestic investment in the recipient country. This share refers to FDI that is used to set up new plants or to expand existing facilities (“greenfield” investment). FDI that comes in to acquire existing assets, either through privatization or through mergers and acquisitions, is investment from the point of view of the firm but not the local economy. Of course, there is the possibility that the asset transfer will be followed by greenfield investment, either as part of a privatization agreement or because the new owner wants to modernize or expand a newly acquired firm.

Even in the absence of greenfield investment, however, foreign capital can provide important benefits to developing economies. In the increasingly globalized world, one of the main challenges for all countries is to increase their competitiveness. Often this involves access to state-of-the-art

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6 Sterilization refers to a central bank buying foreign exchange and then engaging in open markets operations (selling bonds in the domestic market) to offset the liquidity represented by the foreign exchange. Since the interest rate on the bonds will typically exceed that earned by central bank assets, the result is a decapitalization of the institution.

7 UNCTAD (1999a, pp. 162-63) compares coefficients of variation for FDI and other flows. On average, the latter are two or three times as high as the former. For a different view, see Claessens, Dooley and Warner (1995).
technology, which as we have discussed previously is most characteristic of large transnational corporations. With such technology, it is possible to lower unit costs and raise quality at the same time. Thus, it is not surprising that TNCs are major exporters in the world economy, which is one of their attractions to developing countries.

What does the empirical evidence show? At the most general level, there appears to be a positive link between access to foreign capital and higher growth rates. The decline in growth rates in Africa and especially Latin America in the 1980s was closely connected to the debt crisis and resulting closure of capital markets to those regions. Likewise, the return of foreign capital in the early 1990s was part of the explanation for renewed growth. In contrast, the Asian countries where capital flows continued during the 1980s saw no such halt to growth. Certainly foreign capital was not the only variable at play. Domestic economic policies were important, as were cultural and other factors that led to higher domestic savings in Asia than in other regions. Nonetheless, the access to foreign capital makes it possible for developing countries to grow faster than if they had to rely totally on their own resources.8

In the return of foreign capital in the 1990s, foreign direct investment came to represent an ever larger share of capital inflows that themselves increased in developing countries. In 1970, FDI represented around 20 percent of all long-term capital inflows, falling to 5 percent by 1980. By 1990, it was nearly one quarter of all long-term flows and over 65 percent by the end of the decade. While we can assume that virtually all FDI was of the greenfield type in the 1970s and early 1980s, the liberalization policies (privatization and the elimination of restrictions on foreign direct investment) in the late 1980s and the 1990s require additional information on the destination of FDI in recent years. For developing countries as a whole, the share of FDI devoted to acquiring existing assets (whether through privatization or mergers and acquisitions in the private sector itself) is quite low, but it has been rising and there are differences across regions. Latin America has the highest ratio, between 20 and 40 percent in the period 1995-99; for Asia, the share rose from an average of 5 percent in 1991-96 to 12 percent in 1997 and 16 percent in 1998 as a consequence of the financial crisis at the end of the decade.9

While most governments consider FDI to be an attractive kind of foreign capital, which on balance provides significant advantages to developing economies, other kinds of foreign capital can be more problematic. In particular, short-term capital flows frequently lead to volatile growth rates and even to crises in extreme cases. Some of the mechanisms through which this can occur were discussed earlier.

Two prominent cases of such problems occurred during the 1990s. The first was a fairly contained situation that centered on two Latin American countries. In 1992-94, Mexico had been running a very large current account deficit, partly caused by a pegged exchange rate as an instrument to lower inflation. The government did not expect serious problems since much of the deficit was caused by the import of capital goods, which would eventually result in higher growth and more exports. Nonetheless, a series of political shocks during the election year of 1994 undermined investor confidence. When the incoming government tried to bring about a controlled devaluation of the peso, investors (both domestic and foreign) began to withdraw their capital. A full-blown crisis was averted only by a large rescue package led by the IMF and the U.S. Treasury.

For Mexico, the result was a sharp contraction of GDP in 1995 and a fall in real wages that have yet to recover their pre-crisis level. In addition, the banking sector was left in a very weak state that further compounded problems of recovery. Argentina was also affected by the Mexican crisis,

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8 Econometric evidence on this question is mixed. UNCTAD (1999a, p. 341) presents a set of regressions relating FDI to per capita growth. While the coefficients are generally positive, they are significant only for the 1990s. Other studies have shown a positive relationship for Latin America (de Gregorio, 1992; Ffrench-Davis and Reisen, 1998), but a recent cross-regional study of determinants of growth in developing countries (de Gregorio and Lee, 1999) did not find a significant relationship.

9 ECLAC (2000b, p. 71) and UNCTAD (1999b, p. 57). It is important to note, as these publications make clear, that the data for FDI and for mergers and acquisitions are of very different sorts and thus not directly comparable.
since the financial markets came to believe that it too might have to devalue its fixed exchange rate. Although Argentina suffered less than Mexico, it also required an international rescue package. For the rest of the emerging markets, there was a brief increase in interest rates, but little lasting impact. (On the Mexican crisis, see Calvo and Mendoza, 1996; Sachs, Tornell, and Velasco, 1996).

The other case, much more widespread and long lived, began in Thailand in mid-1997. Sharing some characteristics with Mexico in 1994, Thailand was also forced to devalue its currency and again the decline in value went well beyond government expectations and was accompanied by extensive capital flight. In this instance, however, the crisis quickly spread to other countries in the region, especially Indonesia, the Philippines, and Korea. IMF-led rescue packages were again put together. The accompanying conditionality centered on cutting government expenditure and closing troubled financial institutions, which led to severe economic contractions. These policies led to a still ongoing debate about their appropriateness, with many experts arguing that the “remedy” only made the problem worse.

After a brief recovery in the first half of 1998, the crisis spread to Russia. At this point, it severely disrupted international capital markets, even in the industrial countries. It also reached Latin American shores, initially through a speculative attack on the Brazilian currency. Since the still-suffering Asia was an important market for commodities exported by Latin America and other developing countries, trade shocks compounded the financial shocks that virtually shut developing countries out of access to external finance. (On the “Asian” financial crisis and the impact in various regions, see Herman, 1999).

Despite the differences between the two cases, short-term capital flows were generally seen to be an important causal factor in both. Data jointly produced by the BIS, IMF, OECD, and the World Bank give an idea of the behavior of short-term capital flows during the two experiences (see table 6). In both, net short-term external flows fell dramatically after significant positive flows preceding the crises, with almost all of the drop due to bank credits. In the Latin American case, net flows to the two countries most affected fell by nearly $20 billion when comparing pre- and post-crisis years, but still remained slightly positive. In Asia, the drop in the four crisis countries was over $100 billion, and flows became strongly negative.

These similar trends mask the different mechanisms at work in the two cases. In Mexico, the large short-term debt consisted mainly of government obligations that had been converted from local-currency debt when investors became nervous following the assassination of the main presidential candidate and an increase in interest rates in the United States. In Asia, much of the short-term debt was held by the private non-financial sector that took advantage of liberalized regulations to borrow abroad.

The similarity was that investors were unwilling to roll over the short-term debt when it fell due, thus requiring either a moratorium or a rescue package. Since moratoria were not considered legitimate, even by the affected governments, rescue packages with the attached conditionality were

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* Argentina and Mexico. † Malaysia, Philippines, Republic of Korea, and Thailand.

Table 6

NET SHORT-TERM CAPITAL FLOWS DURING RECENT FINANCIAL CRISIS

(billions of dollars)
the answer.\textsuperscript{10} Another similarity that has been noted by some observers is that most of the countries involved in these crises had previously been considered outstanding examples of successful development models. This held for Mexico in Latin America as well as Korea and the second-tier NIEs in Asia. The argument is that foreign investors want to participate in these successful markets and thus capital surges appear, fostered by the so-called herd behavior of investors. The sudden access to large amounts of capital leads to overheating and eventually worrisome signs that lead the “herd” to leave and crises to result (see Ffrench-Davis, 2001).

B. Capital flows and equity

While the globalization of finance can stimulate growth under some conditions, it also has a profound impact on the distribution of the fruits of that growth. In some cases, the link between growth and indicators of equity is positive; in others, the relation is more ambiguous. Overall, the picture that emerges is one of great and perhaps increasing heterogeneity, with some regions, countries, sectors, and social groups taking advantage of the opportunities provided by globalization, while others fall ever further behind.

As we have already seen, there was great diversity in the distribution of capital flows across regions over the last two decades. Table 7 summarizes the pattern, showing clear winners and losers in the period 1970-99. East Asia and the Pacific were the main winners up through 1997, more than doubling their share of total capital flows to developing countries. The Middle East, South Asia, and Sub-Saharan Africa were equally clear losers, especially in the 1990s. Latin America and Europe and Central Asia saw their share decline between 1980 and 1990, but they more or less regained it by 1997. During the crisis years of 1998-99, the main change was the – presumably temporary – decline in capital flows to Asia.\textsuperscript{11}

\begin{table}[h]
\centering
\begin{tabular}{lcccccc}
\hline
\hline
\textit{Total flows} & & & & & & \\
East Asia Pacific\textsuperscript{a} & 19.9 & 15.0 & 27.9 & 38.0 & 24.7 & 31.5 \\
Europe and Central Asia & 5.4 & 9.5 & 12.6 & 16.1 & 19.8 & 18.6 \\
Latin America/Caribbean & 39.1 & 40.1 & 21.9 & 33.4 & 44.0 & 34.7 \\
Middle East/North Africa & 10.6 & 11.5 & 10.2 & 2.3 & 0.9 & 3.2 \\
South Asia & 12.6 & 8.7 & 9.2 & 3.9 & 2.7 & 5.5 \\
Sub-Saharan Africa & 12.3 & 15.3 & 18.1 & 6.3 & 7.9 & 6.5 \\
Total & 100.0 & 100.0 & 100.0 & 100.0 & 100.0 & 100.0 \\
\hline
\textit{Foreign direct investment} & & & & & & \\
East Asia Pacific\textsuperscript{a} & 14.4 & 29.9 & 45.9 & 38.0 & 30.2 & 32.6 \\
Europe and Central Asia & 5.1 & 0.4 & 4.3 & 13.6 & 14.3 & 16.2 \\
Latin America/Caribbean & 58.8 & 138.9 & 33.7 & 37.7 & 48.7 & 42.8 \\
Middle East/North Africa & 15.0 & -74.6 & 10.3 & 3.0 & 0.8 & 2.5 \\
South Asia & 3.7 & 4.2 & 1.9 & 2.8 & 1.7 & 1.8 \\
Sub-Saharan Africa & 5.0 & 1.2 & 3.8 & 4.8 & 4.3 & 4.1 \\
Total & 100.0 & 100.0 & 100.0 & 100.0 & 100.0 & 100.0 \\
\hline
\end{tabular}
\caption{SHARE OF LONG-TERM CAPITAL FLOWS TO DEVELOPING COUNTRIES BY REGION, 1970-2000 (percent)}
\end{table}

\textit{Source:} Calculated from Table 5.

\textsuperscript{a} Developing countries only.

\textsuperscript{10} An interesting exception was Malaysia, which imposed controls on capital outflows and refused to request assistance from the IMF. Later analysis suggests that Malaysia may have been helped by this policy and did not suffer the isolation that was initially expected.

\textsuperscript{11} When viewed on a per capita basis, the regional distribution of capital flows shifts somewhat, but not dramatically. The main difference is that East Asia falls to third place, due to the very large population of China. Using population figures for the mid-1990s (World Bank, 1997) and total capital flows for 1997 (Table 5), the per capita figures are Latin America and the Caribbean $236, Europe and Central Asia $123, East Asia Pacific $75, Sub-Saharan Africa $36, Middle East and North Africa $17, and South Asia $10.
Within the category of foreign direct investment, capital was even more concentrated than for total flows, especially in the 1990s. Thus, while East Asia and Latin America together accounted for 50 to 70 percent of total flows, their share of FDI was nearly 80 percent. Conversely, South Asia and Sub-Saharan Africa together received only about 5 percent of FDI flows compared to 10-20 percent of the total. Insofar as we have argued that FDI is the most important type of capital for investment and therefore growth, these differences have a significant impact. Beyond the regional differences, there is additional evidence of concentration at the country level. According to UNCTAD (1999a, pp. 115-20), in the 1990-97 period, the top ten emerging market economies accounted for over three quarters of all FDI to developing countries. China, Brazil, and Mexico alone received almost half of such investment. Calculating FDI in per capita terms also shows great inequality: Sub-Saharan Africa received less than $5 a year, ASEAN (Association of Southeast Asian Nations) $31, and Latin America $62. Among the highest individual recipients on this measure were Malaysia ($223 per capita), Chile ($170), Mexico ($79), Brazil ($35), and China ($21). The two Sub-Saharan African countries with the largest amount of FDI were Ghana ($6 per capita) and Uganda ($3).

The private capital markets (banks, institutional investors such as insurance companies, pension funds, and mutual funds) have an even stronger preference than do direct investors for the most advanced developing countries, commonly referred to as “emerging markets.” This is because much of their investment is channeled to the private sector through the local stock markets, and these are present in only a limited number of countries. Another instrument is bonds, issued by both private and public borrowers, but again only a limited number of countries can meet the requirements for access to the major bond markets. It should be noted that while these preferences limit poorer countries’ access to foreign capital, the result is that they have also been less afflicted by the international financial crises of the 1990s, since stock and bonds markets were a major channel of contagion.

Poorer countries, then, must rely mainly on official flows: both loans and grants. While these sources of finance have the advantage of low interest rates and long maturities (or no repayment at all in the case of grants), the volume of official development assistance (ODA) has lagged behind that of private flows. Bilateral aid, in particular, fell during the 1990s, from 0.33 percent of the GDP of industrial countries in 1990 to 0.22 percent in 1998 before rising slightly to 0.24 percent in 1999 (OECD, Development Cooperation, various issues). While multilateral funds increased somewhat in nominal terms during the decade, a significant share of these funds was concentrated in a few large countries that were hit by financial crises.12

Table 8 shows the volume of total concessional flows and their allocation during the 1990s. Total funds dropped from $44 billion in 1990 to only $34 billion in 1997, rising to $40 billion in 1999 as a consequence of the crisis. The main decline was in bilateral loans, but multilateral loans and grants were also stagnant or falling. In the regional allocation of these funds, the share going to East Asia rose, especially between 1997 and 1999, while South Asia and Latin America more or less maintained their share, and that of the Middle East and Sub-Saharan Africa fell. The largest increase was in Eastern Europe and Central Asia. As a share of GNP, all regions lost out with the exception of Europe and Central Asia, though once again we see some recovery in 1998-2000.

One issue of concern, then, is the failure of concessional funds – which go mainly to the poorest countries – to keep up with the private funds that are directed primarily toward middle-income countries. A related problem has to do with the high level of debt that characterizes the poorest countries. As a percentage of GDP, the levels are much higher than for wealthier developing countries. The particular mechanism designed to deal with this problem, the so-called HIPC (Highly Indebted Poor Countries) Initiative, has made some progress. Nonetheless, the terms are onerous and the speed slow. Perhaps the most important element is the new link between the HIPC debt negotiations and the World Bank/IMF Poverty Reduction Strategy Papers. The latter are

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12 For an analysis of trends in aid, see World Bank, 1999, chp. 4; 2000. chp. 3.
poverty reduction programs that are designed jointly by governments and various elements of civil society in the respective countries. Although potentially very positive, they have not been in operation long enough to evaluate their effectiveness.\textsuperscript{13}

<table>
<thead>
<tr>
<th>Type of flow (billions of dollars)</th>
<th>1990</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net concessional finance</td>
<td>43.7</td>
<td>33.5</td>
<td>37.3</td>
<td>40.7</td>
<td>40.6</td>
</tr>
<tr>
<td>Grants (excl. technical cooperation)</td>
<td>28.2</td>
<td>26.1</td>
<td>27.3</td>
<td>28.8</td>
<td>29.6</td>
</tr>
<tr>
<td>Loans</td>
<td>15.5</td>
<td>7.3</td>
<td>10.3</td>
<td>11.9</td>
<td>11.0</td>
</tr>
<tr>
<td>Bilateral concessional loans</td>
<td>9.5</td>
<td>-0.1</td>
<td>3.4</td>
<td>5.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Multilateral concessional loans</td>
<td>5.9</td>
<td>7.4</td>
<td>6.9</td>
<td>6.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Memo item</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical cooperation grants</td>
<td>14.1</td>
<td>15.7</td>
<td>16.2</td>
<td>16.6</td>
<td>17.1</td>
</tr>
</tbody>
</table>

Regional allocation (percent)

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</thead>
<tbody>
<tr>
<td>East Asia Pacific\textsuperscript{a}</td>
<td>17.0</td>
<td>14.2</td>
<td>18.2</td>
<td>23.4</td>
<td>21.2</td>
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<tr>
<td>Europe and Central Asia</td>
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<td>17.3</td>
<td>16.1</td>
<td>20.4</td>
<td>20.7</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
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<td>9.2</td>
<td>9.5</td>
<td>8.2</td>
<td>8.0</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>19.9</td>
<td>13.5</td>
<td>11.3</td>
<td>8.4</td>
<td>9.2</td>
</tr>
<tr>
<td>South Asia</td>
<td>12.1</td>
<td>8.2</td>
<td>12.1</td>
<td>10.5</td>
<td>11.3</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>37.3</td>
<td>37.5</td>
<td>32.8</td>
<td>29.1</td>
<td>29.6</td>
</tr>
<tr>
<td>All developing countries</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Percent of regional GNP

<table>
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<tr>
<td>East Asia Pacific\textsuperscript{a}</td>
<td>0.8</td>
<td>0.2</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
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<tr>
<td>Europe and Central Asia</td>
<td>0.1</td>
<td>0.5</td>
<td>0.6</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>0.4</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>2.2</td>
<td>0.8</td>
<td>0.7</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>South Asia</td>
<td>1.3</td>
<td>0.5</td>
<td>0.8</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>5.8</td>
<td>3.8</td>
<td>4.0</td>
<td>3.9</td>
<td>3.9</td>
</tr>
<tr>
<td>All developing countries</td>
<td>0.9</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
</tr>
</tbody>
</table>


\textsuperscript{a} Developing countries only.

Globalization and liberalization seem to have increased the inequality of external savings across regions and individual countries. In addition, they have also contributed to raising inequality within countries. Identifying indicators of domestic inequality is not a simple task. One possibility would be to calculate Gini coefficients to estimate inequality in data from the household income surveys that are now carried out in most countries. The problem is that the surveys do not capture the income of the wealthiest groups in society, who are precisely those most likely to have benefited from globalization.\textsuperscript{14}

An alternative is employment and wage patterns, which will be our main focus here. Almost all empirical evidence shows that expansion of GDP is a necessary condition for employment creation, although it is not usually a sufficient condition. Thus, insofar as financial globalization promotes economic growth, this is good for employment, and increased employment opportunities are positively related to equity. Tight labor markets drive up wages and provide opportunities to those with lower skill levels. That said, there is nevertheless a widespread view that globalization has hurt employment prospects (see, for example, Rodrick, 1997; Kapstein, 1999). What is the basis for this opinion, and what does the evidence say? Much of the controversy centers on the shifting sectoral composition of employment, deriving from the sectoral composition of investment and

\textsuperscript{13} On the Poverty Reduction Strategy Papers and debt reduction, see IDS (2000) and IMF (2000).

\textsuperscript{14} Not surprisingly, then, the most reliable set of cross-national income distribution data shows little change over the past several decades and even some decline in inequality. The main exception is Eastern Europe, where inequality rose markedly between the 1980s and the 1990s. See Deininger and Squire (1996).
growth. Insofar as employment creation is shifting from relatively well-paid jobs in industry and the public sector to low-productivity services, the quality of jobs may be negatively affected.

It is difficult to deal with this topic at the level of developing countries as a whole because of the lack of adequate data, but some insights can be obtained from a recent study of nine countries in Latin America and the Caribbean (Stallings and Peres, 2000). A clear finding is that investment in the 1990s was concentrated in a relatively small number of sectors. Among tradeables, mining and natural gas stood out as did a few branches of manufacturing (cement, steel, petrochemicals, and chemicals). Among non-tradeables, telecommunications was by far the most dynamic. The key point is that all of these sectors are capital intensive. That is, the most dynamic sectors in terms of investment, and thus long-term growth potential, are not producing many jobs. A related finding is that large firms were the most dynamic investors and, among large firms, transnational corporations gained ground vis-à-vis their domestic competitors.

Employment generation was jointly determined by secular trends and the impact of globalization and liberalization. Agriculture continued its long-term decline in total employment, and manufacturing generally lost share, except for the assembly plants (maquila). In manufacturing, most new jobs were created by small firms and microenterprises. These were the only firms that increased employment in Argentina, Brazil, Chile, and Costa Rica, where they accounted for more than 100 percent of net job creation because larger firms posted a net job loss as a result of the downsizing that accompanied modernization.

Within sectors, the branches that grew most rapidly were capital intensive, such as natural-resource based commodities and automobiles. Changes also occurred across sectors. Specifically, activities that had traditionally produced the largest volume of employment, such as textiles and garments, declined across the board. Only the maquila assembly plants, operating under conditions that differ from those of the rest of the economy, provided strong growth in highly labor-intensive activities.

When the fast-growing capital-intensive activities created few jobs, services became the residual source of employment. Services had a heterogeneous performance: high-quality jobs were created in telecommunications, banking, and finance, but most were in low-skill services, leading to slow growth in the overall productivity of the sector. Microenterprises offered the greatest number of jobs, with most of them operating in what the International Labor Organization (ILO) calls the "informal sector."

The heterogeneity in job creation was closely associated with another indicator of equity that centers on wages. Specifically, the 1990s saw a widening wage differential in most countries, developed and developing. Jobs in the large, modern, capital-intensive firms were well paid and offered good fringe benefits (especially health care and social security). Jobs in the small, traditional, labor-intensive shops tended to be poorly paid and often without benefits; this was especially true in the informal sector. Although the wage gap can be measured in a variety of ways, the most common is according to educational characteristics as a proxy for skills. In the study mentioned above of nine Latin American and Caribbean countries, there was a widening gap in seven of the nine during the 1990s. For the group as a whole, the gap grew by 11 percent when university graduates were compared to those earning the average wage and by 25 percent when university graduates were compared to those with 7-9 years of schooling (Stallings and Peres, 2000, p. 127).

C. Capital flows and government autonomy

One explanation for the particular pattern of resource flows that has emerged in the last two decades, both with respect to type of capital and its distribution, is that globalization limits the power of governments to follow desired policies. According to this argument, for example, governments can no longer use capital controls, which would restrict the entry or departure of all or certain types of
capital. Nor can they follow the kinds of redistributive policies they would prefer. The constraints are
described to come from the international financial institutions (IFIs) or “the markets.”

There is certainly some truth to these allegations, but perhaps less than is often believed. To
begin with the question of macroeconomic policies, deficits – fiscal and current account – are the item
that the markets (and the IFIs) most object to. A large deficit is seen as an indicator that government
policies are inadequate and that serious problems may be in the offing. Confronted by such a deficit,
and if no policies are in place to reduce it, investors may withdraw their funds. While this action can
have the effect of inducing the very crisis that is feared, it is logical from the microeconomic
viewpoint since those who wait are more likely to lose the money they have invested. The issue of
deficits, however, should be seen in another light. Experience has shown that large deficits are not a
desirable policy outcome (except, perhaps, as a Keynesian response to a situation of deep recession),
so the inability to maintain them is not a result that should be lamented. Redistributive policies are
better pursued within the context of reasonable macroeconomic equilibrium.

Capital controls present a different set of issues. The old style of controls aimed to prevent
capital from leaving a country, often to enable loose macroeconomic policies to be followed. More
recently, the emphasis has been on restrictions on the entry of capital to avoid surges that can then
leave as rapidly as they arrived and cause both recessions and banking problems in the process.
While the IMF was initially against such controls, some countries used them in any case. Chile is
the best known example, but Colombia and Brazil followed a similar policy through different
instruments. Malaysia later applied temporary controls on capital leaving the country. After the
Asian crisis, and increasing evidence that large amounts of “hot money” can move around the globe
very rapidly and overwhelm the economies of even well managed developing countries, opinion
began to change. There is now more openness to some type of controls, but as a complement to, not
a substitute for, sound macroeconomic policy (see Herman and Stallings, 1999). This area thus
offers an example of when well-designed domestic policies can influence international thinking.

The third set of policies that is relevant to the topic of policy autonomy concerns
redistributive measures, ranging from taxes and expenditures to subsidies for certain groups to
redistribution of assets. This is where governments encounter the greatest resistance to policy
initiatives, but it comes as much or more from domestic groups as from foreign investors. Clearly
foreign investors like to have low taxes and subsidies for infrastructure and so on, but other factors
are also important in investment decisions. Certainty about the rules and predictability about policy
in general are major considerations; other factors of importance depend on the sector and the target
market (Maxfield, 1999). In all cases, however, for both domestic and foreign investors, property
safeguards are crucial. Here globalization, especially the ability to move money rapidly from one
place to another, indeed limits the autonomy of governments, and it has taken certain issues
virtually off the agenda. Examples include land reform or expropriations of any kind, unless they
are fully compensated. But, as with deficits, attempts to redistribute through this type of policy have
not produced very good results in the past, so the constraint may actually be beneficial in the long
run if it leads governments to design and implement more effective redistributive measures.

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15 For a sophisticated version of these arguments, see Held et al (1999, pp. 227-34).
IV. Conclusions: Recommendations for Policy Change

To summarize, we have argued that the globalization of finance can provide important support for higher growth rates in developing countries, but that the composition of capital flows is crucial. FDI is positive through its impact on investment, while short-term flows may well have a negative effect by increasing volatility. At the same time, financial globalization has led to increased inequality as poorer countries are reliant on declining official flows, while middle-income countries are beneficiaries of expanding private flows. Since the latter are more volatile, however, the benefits are offset to some extent. Inequality has also increased within countries, due in part to the employment patterns generated by international investors. Finally, globalization has constrained government action to some extent, although less than is sometimes believed. The main constraints are the requirement for certainty about rules and the inviolability of private property, so that governments must find ways to offset the inequality generated by globalization without transgressing in these two areas.

Both international and domestic policy changes are needed if developing countries are to maximize the benefits and minimize the costs from the new world environment created by globalization. Unfortunately these countries have little voice with respect to international policies, which are mainly determined by the major developed countries together with the international financial institutions. They can, however, largely determine their own policies. In this final section, we will outline both international and domestic policies that would improve the functioning of the global system from
the point of view of the developing countries. We also make some suggestions on policy initiatives at the regional level that can usefully complement the other two.  

A. International policies

Much has been said since the Asian crisis began in 1997 about the need for a “new international financial architecture,” but little has actually been accomplished. Among the agenda items that are under discussion, we can identify five that would be particularly important for developing countries in terms of lowering the chances of destructive international crises and establishing adequate mechanisms for dealing with them when they do arise.

- Consistent macroeconomic policies at the global level: The lack of a commitment to maintain adequate and stable growth rates in the developed countries is a major problem. The resulting boom-bust cycles are transferred to developing countries through trade as well as financial channels, and their impact is much more serious.

- Enhanced financial regulation and supervision plus improved information flows: The international financial system, which is dominated by institutions from the developed countries, needs to increase its transparency and coordinate its regulatory frameworks as another way to limit the tendencies toward boom-bust behavior and to create a more “level playing field.”

- Reform of the IMF so as to provide adequate international liquidity in times of crisis: When crises do occur, international liquidity must be maintained. The IMF is the institution that has been designated for this role, but it currently lacks both the funds and an adequate mandate.

- Sharing the costs of adjustment: Another measure to deal with crises has to do with assuring that the lenders share in the costs, rather than leaving borrowers to cope with all of the consequences (the equivalent of international bankruptcy procedures). For this to happen, internationally sanctioned stand-still provisions must be included in loan documents to avoid legal difficulties and free-riding among creditors.

- Debt alleviation for the least developed countries: The slow speed with which the HIPC negotiations have proceeded has further increased the burden on the poorest of the developing countries. Debt alleviation is the most efficient ways of offsetting the disadvantages that currently face them.

B. Domestic policies

Given their limited ability to affect international decision making, developing countries must put priority on designing and implementing domestic policies that protect themselves from crises. The intent is not to return to the closed economies of the earlier postwar period, but to improve the operation of the more open system of the 21st century. Five areas are of special importance:

- Anti-cyclical macroeconomic policies: Just as it is important to avoid boom-bust cycles at the international level, this aim should also be pursued within developing economies. Experience indicates that pro-cyclical policies slow average growth in the long run because they deter investment, both foreign and domestic.

- Control of foreign capital surges: One of the main ways that boom-bust cycles have originated or been exacerbated is through large amounts of capital entering a country at the same time (the

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This section draws heavily on the policy recommendations that several United Nations units have put forward in the last two years. See especially United Nations (1999), Herman (1999), UNCTAD (1999a), and the documents related to the upcoming international meeting on “Financing for Development” (http://www.un.org/esa/analysis/fid).
so-called herd behavior). Since these flows tend to exit in the same way, it may be sensible to slow down the original entry. This is also important since capital surges can interfere with maintaining stable domestic macroeconomic policy.

- **Policies to encourage domestic savings**: Since one of the main reasons that developing countries rely heavily on external resources is lack of domestic savings, policies to stimulate the latter should be included as an element of macroeconomic policy. Of course, high growth rates are the best way to increase savings, so there is necessarily a problem of cause and effect in this area.

- **Improved regulation and supervision of the financial sector**: International financial crises can wreak havoc on the local banking sector in developing countries, which compounds the difficulties of returning to a new growth path afterwards. The best way that developing countries can protect themselves is through strong regulation and supervision of local financial institutions; this may involve higher standards of capital adequacy than are required internationally.

- **Policies to offset the inequality that frequently results from financial globalization**: Since developing countries are part of the global system that tends to increase inequality, domestic policies must counteract this trend insofar as possible. In particular, the domestic inequality across economic sectors and social groups must be moderated, but the policies must not simultaneously cut investment and thus growth. One of the best examples of policies that will promote both growth and greater equality is support for small firms. Others include labor-intensive growth strategies, with a special emphasis on infrastructure, and efficient social spending, especially in education.

### C. Regional policies

Although most attention has centered on the international or domestic levels, regional arrangements can help strengthen domestic policy initiatives, especially in the absence of movement on the international front. Four areas should be the focus of attention:

- **Peer review of policies**: Since neighboring countries will suffer when one country in a region follows irresponsible policies, one of the most effective ways to avoid the latter is to establish a system whereby neighbors monitor each other's performance.

- **Regional schemes to increase liquidity in times of crisis**: International sources of liquidity may be delayed in arriving in times of crisis, either because of bureaucratic inertia or disagreements over conditionality. To avoid long delays in which a crisis can worsen, regional financial institutions can help to plug the gap.

- **Regional integration policies to encourage trade and investment**: Increasingly, both in the developed and developing worlds, economic interactions are centered on regional integration groupings. Experience in Asia as well as Europe suggests that promoting regional integration is a useful way to raise growth rates.

- **Joint negotiations at the international level**: One of the main problems that developing countries face is lack of influence in determining how the global economy operates. Even the largest developing countries have little international clout, but if they negotiate as regional groups, they can magnify the weight of their opinions.
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