

# **Issues in Macroeconomic and Financial Policies, Stability and Growth**

**Working Paper No. 73**

**Yilmaz Akyüz\***

**Policy Integration Department  
International Labour Office  
Geneva**

July 2006

Working papers are preliminary documents circulated  
to stimulate discussion and obtain comments

\* Former Director of Division on Globalization and Development Strategies, and Chief Economist, UNCTAD; and second holder of Tun Ismail Ali Chair in Monetary and Financial Economics, University of Malaya, Kuala Lumpur.

Copyright © International Labour Organization 2006

Publications of the International Labour Office enjoy copyright under Protocol 2 of the Universal Copyright Convention. Nevertheless, short excerpts from them may be reproduced without authorization, on condition that the source is indicated. For rights of reproduction or translation, application should be made to the Publications Bureau (Rights and Permissions), International Labour Office, CH-1211 Geneva 22, Switzerland. The International Labour Office welcomes such applications.

Libraries, institutions and other users registered in the United Kingdom with the Copyright Licensing Agency, 90 Tottenham Court Road, London W1T 4LP [Fax: (+44) (0)20 7631 5500; email: [cla@cla.co.uk](mailto:cla@cla.co.uk)], in the United States with the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923 [Fax: (+1) (978) 750 4470; email: [info@copyright.com](mailto:info@copyright.com)] or in other countries with associated Reproduction Rights Organizations, may make photocopies in accordance with the licences issued to them for this purpose.

---

ISBN 92-2-119179-6 and 978-92-2-119179-7 (printed version)  
92-2-119180-X and 978-92-2-119180-3 (web version)

*First published 2006*

*Cover*

---

The designations employed in ILO publications, which are in conformity with United Nations practice, and the presentation of material therein do not imply the expression of any opinion whatsoever on the part of the International Labour Office concerning the legal status of any country, area or territory or of its authorities, or concerning the delimitation of its frontiers.

The responsibility for opinions expressed in signed articles, studies and other contributions rests solely with their authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them.

Reference to names of firms and commercial products and processes does not imply their endorsement by the International Labour Office, and any failure to mention a particular firm, commercial product or process is not a sign of disapproval.

ILO publications can be obtained through major booksellers or ILO local offices in many countries, or direct from ILO Publications, International Labour Office, CH-1211 Geneva 22, Switzerland. Catalogues or lists of new publications are available free of charge from the above address, or by email: [pubvente@ilo.org](mailto:pubvente@ilo.org)  
Visit our website: [www.ilo.org/publns](http://www.ilo.org/publns)

---

Printed by the International Labour Office, Geneva, Switzerland

---

*Abstract:* By historic standards, world economic growth has been relatively low and unstable in the past two decades. Its instability is due to the financial liberalization in developing countries, creating low demand and causing problems in unemployment, government debt and deficits, and trade imbalances. The challenge is bringing more rapid and stable growth and spreading the benefits of globalization more equally worldwide. Policymakers should focus on rapid capital accumulation and job creation through new approaches in macroeconomic and financial policies and global mechanisms. Objectives include multilateral discipline, international policy coordination, overcoming unemployment, poverty, and creating good economic relations. The paper suggests reforming the IMF's approach on its lending strategies to low and middle income countries, better crisis intervention and debt workout mechanisms as well as transforming the IMF into a more multilateral institution. It also recommends reforming the G3 exchange rate structure, better governance in international capital flows, regulating capital accounts, ensuring exchange rate stability, and having more consistent policies for higher growth.

*JEL classification:* E61, F33, F43, J08.

*Résumé:* D'un point de vue historique, la croissance économique mondiale a été relativement basse durant les deux dernières décennies. De plus, la libéralisation financière dans les pays en voie de développement a été un facteur d'instabilité qui a été à l'origine d'une demande généralement basse ainsi que d'un certain nombre de problèmes dans les domaines de l'emploi, des dettes du gouvernement et des déficits, et des déséquilibres dans la balance commerciale. Le défi est de promouvoir une croissance économique plus stable et rapide et une globalisation plus juste pour tout le monde. Ceci exige que des politiques économiques favorisant l'accumulation du capital et la création d'emplois à l'aide de nouvelles approches macroéconomiques et financières et de mécanismes globaux. La discipline multilatérale, la coordination des politiques économiques, la création d'emplois et la lutte contre la pauvreté sont tous des objectifs importants. L'article suggère que le FMI réforme son approche en matière de prêts aux pays à revenus moyens et faibles, ainsi que les mécanismes d'intervention dans les crises économiques. Le FMI doit aussi devenir une institution plus multilatérale. Pour une meilleure croissance, il recommande aussi de reformer la structure du G3 pour les taux de change, mieux gérer les flux de capitaux internationaux, régler les comptes capitaux, assurer la stabilité du taux de change, et mettre en œuvre des politiques plus cohérentes.

*Classification JEL:* E61, F33, F43, J08.

*Resumen:* Si se toman en cuenta tendencias históricas, el crecimiento económico mundial ha sido relativamente bajo en las últimas dos décadas. Su inestabilidad se debe a las liberalización financiera operada en los países en desarrollo, creando una baja demanda y causando problemas de desempleo, deuda pública, déficit fiscal y des-balances en el comercio. El desafío es crear un crecimiento más rápido y estable diseminando los beneficios de la globalización en forma más equitativa a través de todo el mundo. Los tomadores de políticas deberían focalizar su atención en la acumulación del capital y en la creación de empleos a través de nuevos enfoques en las políticas macroeconómicas y en las políticas financieras, así como en mecanismos globales. Los objetivos deberían incluir disciplina multilateral, coordinación internacional de políticas, combate al desempleo, pobreza y creación de buenas relaciones económicas. El trabajo sugiere reformar el enfoque del FMI, en relación a sus estrategias de préstamos a países de bajo y mediano ingreso, una mejor intervención en las crisis y mejores mecanismos de programación de deuda, además del de transformar al FMI en una institución más multilateral. También recomienda la reforma de la estructura de tipos de cambios del G3, una mejor gobernanza en los flujos de capital, una regulación de cuentas de capital, asegurando una estabilidad en los tipos de cambios y poniendo e políticas más consistentes para un mejor crecimiento.

*Clasificación JEL:* E61, F33, F43, J08.

---

## The Policy Integration Department

The Policy Integration Department pursues the ILO's decent work and fair globalization agenda from an integrated perspective. Its central objective is to further greater policy coherence and the integration of social and economic policies at the international and national level. To this end, it works closely with other multilateral agencies and national actors such as Governments, trade unions, employers' federations, NGO's and universities. Through its policy-oriented research agenda, it explores complementarities and interdependencies between employment, working conditions, social protection, social dialogue and labour standards. Current work is organized around four thematic areas that call for greater policy coherence: Fair globalization, the global poor and informality, macroeconomic policies for decent work, and emerging issues. Working papers disseminate research findings at an early stage in order to obtain comments, and are thus preliminary documents.

Director: *Duncan Campbell*

Research Advisor: *Rolph van der Hoeven*

This paper was initiated by *Rolph van der Hoeven*.

By examining the impact of macroeconomic and financial policies on growth, employment and incomes, it is a contribution to the department's work on international policy coherence and fair globalization.

---

# Issues in Macroeconomic and Financial Policies, Stability and Growth

## Contents

	<i>Page</i>
<b>A. Global Demand, Growth and Employment.....</b>	<b>1</b>
<b>B. Growth and Imbalances in the Industrial World.....</b>	<b>2</b>
1. Recent Record.....	2
2. Rethinking Macroeconomic and Financial Policies .....	4
3. Promoting Global Demand and Reducing Imbalances and Instability .....	6
<b>C. Stability and Growth in Developing Countries .....</b>	<b>8</b>
1. External Financing and Adjustment .....	8
a. Resource Gap, Development Finance and Growth.....	8
b. Current Account Financing and Payments Adjustment.....	9
2. Financial liberalization and the labour market.....	11
a. Financial and Macroeconomic Instability and Investment.....	11
b. Financial Boom-Bust Cycles and the Labour Market .....	12
3. Preventing Boom-Bust Cycles and Financial Instability .....	14
<b>D. Summary and Conclusions.....</b>	<b>17</b>
References .....	19



---

# Issues in Macroeconomic and Financial Policies, Stability and Growth

## A. Global Demand, Growth and Employment

During the past two decades of liberalization-cum-globalization, world economic growth has been low by historical standards. According to some estimates, between 1960 and 1980 global output per person rose by over 80 per cent while this figure was 33 per cent between 1980 and 2000.<sup>1</sup> The past three years do not show any significant deviation from this trend: on average, world output growth during 2001-2003 remained even below the average rate for 1980-2000. Despite the acceleration in 2003 and 2004, growth for the first years of the new millennium has on average only been about 0.6 percentage points higher than in the 1980s and 1990s.<sup>2</sup>

Growth has also become more erratic, largely due to rapid financial liberalization and closer global integration. Financial developments have had considerably increased influence over economic cycles, and increased financial instability associated with greater mobility of capital has been mirrored by sharp and unexpected changes in economic activity. This is particularly true for developing countries, including those with a good record of macroeconomic policy discipline and successful industrialization and development.

Insufficiency of the overall level of demand has proved to be a major impediment to sustained growth while disparities in demand creation have been a prime source of instability in the international monetary and financial system, and tensions in international trade. These twin phenomena have been responsible for problems that have increasingly become structural, such as unemployment, government debt and deficits, and trade imbalances.

The challenge facing national and international policy makers is how to bring about faster and more stable growth, and to ensure that its benefits are widely shared both across and within countries. Creating conditions for rapid capital accumulation, both human and physical, and job creation hold the key to success. This calls for a new approach to macroeconomic and financial policies both in industrial and developing countries, as well as new global mechanisms to facilitate international policy coordination and to bring multilateral discipline to macroeconomic and financial policies of countries having a disproportionately large impact on global economic conditions.

<sup>1</sup> Weisbrot, Naiman and Kim (2001).

<sup>2</sup> Unless otherwise stated, figures used in this section are from various issues of IMF World Economic Outlook and the World Economic Outlook database (as of September 2005).

---

## **B. Growth and Imbalances in the Industrial World**

### **1. Recent Record**

At some 2.6 per cent per annum average growth in industrial countries in the past two decades has remained below the 3 per cent threshold which is generally considered as the minimum rate needed to make a dent in unemployment and bring tangible improvements in per capita income. Consequently, the unemployment rate has remained high, close to 7 per cent, compared to around 4 per cent during the 1970s and 1960s.<sup>3</sup>

There is, however, considerable disparity among industrial countries in their growth performance and contribution to global demand. Until the 1990s growth in Western Europe and the United States was broadly similar while in Japan it was markedly faster than growth in both regions. In the past ten years average growth in the United States has been higher than that in the European Union (EU) by over one percentage point, and in Japan by two percentage points. More importantly, the United States economy has provided a major growth stimulus to the rest of the world through trade, with its total domestic demand rising 0.5 percentage points per annum faster than its GDP. In Japan and the EU, by contrast, GDP growth exceeded growth in domestic demand.

The outcome has been widening trade imbalances, a rapid build up of United States external debt and accumulation of dollar assets in the rest of the world. While the net international investment position of the United States, including direct investment, was positive at some \$360 billion in 1980, it has constantly deteriorated in the past two decades and reached minus \$2500 billion at the end of 2004. Currently its gross external debt exceeds \$8800 billion, largely denominated (around 90 per cent) in dollars.<sup>4</sup>

The way in which macroeconomic policy has been conducted has made a major contribution to persistent imbalances. With the exception of Japan, fiscal policy has barely been used for macroeconomic management since the beginning of the 1980s. Systematic resort to fiscal policy tools for counter-cyclical purposes has been eschewed in the belief that, once deregulated and freed from high taxes, the economy would not need management of this sort, since the private sector would generate the requisite level of demand. This thinking held sway in the United States where, despite its financial orthodoxy and anti-Keynesian rhetoric, the supply-side experiment beginning in the early 1980s left a legacy of a large public debt. A similar process is now under way, as cuts in taxes of high-income groups are giving rise to mounting budget deficits and new public debt without adding much to effective demand and employment. Such an approach to public budget does not allow automatic stabilizers to work effectively, and eventually makes it necessary to introduce fiscal retrenchment, adding to instability.

In Europe, an important objective of macroeconomic policy in the 1980s was to bring about convergence in monetary and financial conditions, rather than economic growth and employment generation. More recently, the pursuit of strict rules imposed by the Growth and Stability Pact regarding fiscal deficits and inflation without due attention to the phase of economic cycles have precluded active use of macroeconomic policy to address chronic

<sup>3</sup> See OECD (2005: p. 237) and OECD Labour Force Statistics (various years).

<sup>4</sup> For the net investment position see Abaroa (2004, table 2) and Bureau of Economic Analysis (2005). Gross external debt position figures are for end of June 2005; see United States, Department of Treasury (2005).

---

unemployment, which has averaged at 9 per cent in the euro area. The region has run into a dilemma as slower growth, rising unemployment and higher interest rates have fed into increased public deficits and debt.

Monetary policy in Japan and the United States has often ignored the developments in financial markets, and this has had consequences for the strength and sustainability of growth over the longer term. In Japan, the policy of rapid liquidity expansion pursued in response to the appreciation of the yen after the 1985 Plaza meeting was a major factor in the emergence of a stock market and investment bubble, and the consequent financial difficulties that pervaded the banking and corporate sectors plunged the economy into a persistent deflation and compromised its ability to sustain growth despite repeated fiscal stimulus packages in the past ten years. In the United States during the economic expansion in the 1990s policy makers adopted a benign neglect of financial conditions and increased fragility resulting from excessive investment in high-tech sectors, supported by a stock market (dot.com) bubble and highly inflated and leveraged asset prices. Occasional rescue operations conducted by the Fed over the past two decades (e.g. during the 1987 stock market turmoil or the 1998 Long Term Capital Management debacle) also appear to have created moral hazard, encouraging financial excesses and adding to the bubble. The subsequent bursting of the bubble at the turn of the millennium has thus created difficulties in achieving a strong recovery based on investment and employment growth.

It is generally agreed that in the presence of large disparities in demand creation in the industrial world, exchange rate movements would be quite powerless in securing an orderly adjustment to persistent payments imbalances. However, given that currency movements are governed by short-term, speculative influences rather than trade imbalances and the underlying fundamentals, their behaviour has often added to imbalances and instability originating from inconsistencies in the stance and mix of policies. Rather than facilitating orderly balance-of-payments adjustment and removing asymmetries between deficit and surplus countries, major reserve currencies have manifested persistent misalignments and gyrations over the past two decades. As seen during the 1980s and 1990s, faster expansion of economic activity in the United States often attracted large foreign capital into that country, and the dollar moved up rapidly alongside mounting trade deficits until sudden changes in market sentiments took it to lower levels in a relatively short time. Such boom-bust cycles in the dollar have been the single most important factor contributing to international monetary instability.

As inflation ceased to be a major problem, there has been a tendency for increased reliance on currency adjustments to reduce trade imbalances and revive growth. This has been particularly pronounced in the recent downturn of the United States economy and the weakening of the dollar when many countries, including Japan, have resisted the appreciation of their currencies by intervening in the foreign exchange market, thereby slowing the correction of trade imbalances. This strategy has been motivated by two factors. First, since most of these countries depend heavily on exports to the United States, further depreciation of the dollar would slow their growth. Secondly, it would also deplete the value of the dollar assets concentrated in the hands of surplus countries. These events have evoked the memories of the competitive devaluations of the inter-war period, creating frictions in the international trading system.

All these have had serious repercussions for developing countries. As a result of greater integration of developing countries into the global financial system, sharp swings in monetary and financial conditions in the major industrial countries tend to generate boom-bust cycles in capital flows to these countries. For instance the sharply increased capital flows to Latin America during the early 1990s was closely linked to the downturn in economic activity, low interest rates and excess liquidity in the United States economy. The subsequent recovery in the United States, the rise in interest rates and asset prices played an important role in the reversal of capital flows, leading to a series of crises in

---

emerging markets, beginning with Mexico in 1995. Again, more recently, with the decline in interest rates to unprecedented levels and expansion of international liquidity, private capital has started to flow into some East Asian economies with strong payments positions, raising the risk of unsustainable bubbles.<sup>5</sup>

## 2. Rethinking Macroeconomic and Financial Policies

The debate over macroeconomic policy in the past two decades has been dominated by a perceived trade-off between inflation and employment. It has been widely believed that expansionary policies that attempt to reduce unemployment below a certain level (the so-called natural rate or NAIRU) would ultimately accelerate inflation. Accordingly, monetary policy has been conducted, particularly in Europe, by monitoring the evolution of unemployment in relation to NAIRU and/or actual GDP growth in relation to its estimated potential growth.

This fear of inflation has led to a low-growth, high-unemployment hysteresis. This is because neither NAIRU nor potential growth is impervious to the stance of macroeconomic policies.<sup>6</sup> The tendency for actual output to fall short of potential is often corrected by reducing the growth of the latter, resulting in higher structural unemployment. When central banks prevent the economy from growing faster than, say, 2.5 per cent (except temporarily during recovery from recession) on grounds that this would lead to an acceleration of inflation, firms will not be inclined to expand capacity any faster. Consequently, output growth will be little more than what is possible utilizing productivity growth alone, inevitably leading to mounting unemployment. As the number of long-term unemployed increases, skills would be lost and the unemployment rate at which wages start to exceed productivity growth starts increasing, pushing up the natural rate.

Recent years have seen a gradual decline in unemployment in some OECD countries and this has often been associated with a deceleration in inflation despite the absence of significant changes in labour market institutions and practices. Perhaps the most interesting case is the United States. As recently as 1995, many economists suggested that the United States economy could not stand much faster growth rates than some 2.7 per cent without inflation,<sup>7</sup> but growth in that economy averaged at 4 per cent during the rest of the decade, with unemployment falling to 4 per cent in 2000, a level well below the previously estimated NAIRU for the United States, and annual inflation barely exceeded 2 per cent. Similarly in a number of countries in the EU, including Spain, Netherlands and Sweden, the unemployment rate was halved in the second half of the 1990s while inflation either showed a tendency to decelerate or stayed relative stable at around 2 per cent.

Indeed, an important consequence of closer economic integration over the past two decades is that inflation is no longer a major threat in the industrial (and, for that matter, developing) world. While there can be one-off price increases due to supply shocks, the kind of wage-price spirals that pervaded the industrial world during the 1970s and early 1980s are now not very likely. Deflation has replaced inflation as the main threat facing the world economy in recent years.

<sup>5</sup> See Pesek (2003) and Williams (2004).

<sup>6</sup> For a detailed treatment of these issues see Akyüz (1998a) and UNCTAD TDR (1995, Part Three, chap. III).

<sup>7</sup> See Newsweek September 18, 1995, pp. 38-39.

---

The first reason for increased price stability is related to financial liberalization and integration. Evidence suggests that financial globalization has promoted greater price stability in both industrial and developing countries.<sup>8</sup> This is likely to reflect the “disciplining” effect of financial liberalization and increased capital mobility on monetary policy. Fear of capital flight and financial turmoil serves to reduce tolerance with inflation and promotes monetary orthodoxy, hence leading to lower growth and higher unemployment. For the same reason it may also have a “taming” effect over wages and prices.

More importantly, the internationalization of production resulting from rapid trade liberalization, increased mobility of foreign direct investment (FDI) and greater spread of international production networks promote less aggressive wage and price behaviour. Workers and businesses in countries more open to trade and dependent on FDI constantly feel the pressures of foreign competition, and run the risk of pricing themselves out. These should certainly dampen inflationary pressures.<sup>9</sup>

However, contrary to what was expected by orthodoxy, greater monetary discipline and price stability have not resulted in increased financial and macroeconomic stability. As noted above, as a result of financial liberalization, developments in asset and credit markets have increasingly shaped business cycles, causing sharp fluctuations in economic activity. In view of the growing influence of finance on economic performance, attention has increasingly turned on the way and means of securing greater financial stability.<sup>10</sup>

On one view, central banks should pursue financial stability, rather than price stability, as their main objective, as was originally the case with the Fed, and focus on conditions in financial markets rather than in labour and product markets.<sup>11</sup> Clearly, to the extent that tolerable inflation range is widened, this task becomes less challenging. Alternatively, consideration could be given to the use of full range of regulatory tools, making counter-cyclical adjustments to rules governing provisions, capital requirements, collateral valuation and other measures affecting conditions in credit and asset markets, including circuit breakers in stock markets (such as margin requirements), in order to limit the cyclicity of the financial system.<sup>12</sup> In practice, a combination of monetary policy with counter-cyclical use of regulatory tools may present itself as the best way of dealing with financial instability and avoiding its adverse consequences for economic activity.

<sup>8</sup> Tytell and Wei (2004). However, there is no evidence that financial globalization has encouraged low budget deficits.

<sup>9</sup> For the impact of trade liberalization on inflation see Romer (1993). The study by Tytell and Wei (2004) mentioned above also finds an inverse relation between trade openness and inflation, as well as stronger association between FDI and low inflation.

<sup>10</sup> See McCauley (2001).

<sup>11</sup> This is the view advocated by Kindleberger (1995).

<sup>12</sup> For a discussion of this issue see BIS Annual Report (2001), chap. VII, “Cycles and the financial system”.

---

### 3. Promoting Global Demand and Reducing Imbalances and Instability

It should however be recognized that in pursuing the twin objectives of growth and financial-cum-macroeconomic stability, policies in individual countries today face much greater constraints than in the past. As production has become increasingly globalized, the scope for effective demand management has been greatly reduced. Similarly, financial globalization has increased the vulnerability of economies to payments difficulties. As a result countries are inclined to pursue beggar-my-neighbour strategies based on expansion of exports and attraction of foreign capital. However, such mercantilist strategies face the problem of fallacy of composition since the objectives pursued cannot be attained by all the countries at the same time. Thus, global demand deficiency is a recipe for invitation to conflict among nations.

It has long been recognized that raising the overall level of demand and reducing disparities in demand creation would call for a close coordination and cooperation among the major industrial countries. Indeed, given rapid global economic integration and growing interdependence, no country can be expected to be able to put its house in order with its own action alone irrespective of what the others are doing, and this is as much true for the United States or the EU as for smaller and poorer countries.

It is now increasingly agreed that the United States economy cannot act as an engine for growth for the rest of the world indefinitely.<sup>13</sup> As the events in the past few years have shown, the excessive dependence on the United States markets generate not only economic but also political instability. Consequently, Japan and the EU would need to assume greater responsibility in promoting global demand and employment, and they should cease to rely on exports for growth. This would allow the United States to reduce its twin deficits without a significant sacrifice from growth. Otherwise, the correction of the United States fiscal and trade deficits would set a process of downward convergence and reduce global growth and employment. It could also cause frictions in the trading system.

There can be little doubt that there are certain structural impediments to moving permanently to a higher growth path in both Japan and Europe. However, tight macroeconomic policies and sluggish growth would only make solution to such problems more difficult. The need for expansionary macroeconomic policies has also been recognized by the IMF whose recent policy advice to the EU and Japan has been distinctly Keynesian, while insisting that longer term solutions to unemployment and fiscal imbalances in the euro area and to deflation in Japan would call for structural reforms.<sup>14</sup>

<sup>13</sup> This has been clearly recognized by the IMF (2003c, p. 25): “looking forward it seems unlikely that the United States can or should provide the degree of support to the global economy over the medium term that it has in the past”.

<sup>14</sup> In response to the slowdown in the world economy in 2001 and 2002), the Fund policy advice to the EU has been to temporarily suspend the targets set for fiscal deficits in the Stability and Growth Pact and to pursue more aggressive interest rate cuts. For instance, the Fund urged the ECB to continue easing monetary policy and warned against the risks of “adding to economic headwinds through excessive fiscal retrenchment” and advocated “full play of automatic stabilizers” (IMF 2003b, p. 27). On Japan, it pointed out “the urgency of taking aggressive action to reestablish positive inflation”, asking the Bank of Japan to be “more aggressive in both its actions and communications”, and favouring only “gradual fiscal consolidation”. (IMF 2003b, p. 30). See also IMF (2003c, pp. 26-31). More recently, the Fund has pointed out that “slow wage and employment growth and lagging confidence have held back consumption” contributed to the low growth in the

---

Clearly, a consistent and coherent set of macroeconomic policies designed to raise the level of global demand and reduce trade imbalances among the major industrial countries would be an important step in attaining stability of capital flows and exchange rates. However, given the size and mobility of international capital, and the tendency of currency markets to amplify the effects of policy shocks and to generate disturbances on their own, exchange rate stability requires more than macroeconomic policy coordination. It calls for improved governance over international capital flows. Serious consideration should be given to possible ways and means of reducing the scope of capital movements and currency markets for generating disruptions and instability. This is all the more important for developing countries since it is open to question whether these countries can attain exchange rate stability by their own action when the currencies of the major industrial countries are subject to misalignments and gyrations. The post Bretton Woods experience clearly suggests that the global economy will not achieve greater stability without some reform of the G3 exchange rate regime, and that emerging markets remain vulnerable to currency crises as long as major reserve currencies are highly unstable.

The kind of policy coordination needed to address these issues has not been forthcoming. Countries have been pursuing policies in their own best perceived interests, largely ignoring their global repercussions as well as their consistency with policies pursued elsewhere. The Group of 7 does not provide an effective forum for policy surveillance and coordination. Similarly, existing global arrangements lack effective mechanisms to ensure coherence and consistency among the macroeconomic and financial policies of the major industrial countries. In this respect, governance in these areas lags behind that for international trade, where multilateral discipline is part of the WTO regime, however imperfect it may be.

The IMF conducts bilateral surveillance of individual countries' policies through annual Article IV consultations and multilateral surveillance through periodic reviews of global economic conditions in the context of the World Economic Outlook. However, IMF surveillance has not been successful in attaining rapid and sustained growth, removing serious payments imbalances and achieving greater international monetary and financial stability because of shortcomings of existing procedures. As a multilateral institution, the Fund has effectively no power to exercise policy discipline over its non-borrowing members, including particularly its major shareholders. Its procedures give too little recognition to the disproportionately large global impact of macroeconomic and financial policies in major industrial countries while leaning heavily on poorer countries drawing on the Fund.

Multilateral financial institutions remain the only legitimate and appropriate fora for securing policy consistency and coherence among major industrial countries with a view to their effects on global growth and stability. But if such a function is to be preformed effectively, it is necessary to reform not only the surveillance procedures but also the governance of these institutions, including its voting structure and decision-making procedures. This constitutes one of the greatest challenges in establishing a genuinely multilateral system in support of stability and growth.

euro area. Since inflation is low and “[u]nderlying price pressures, including wage and unit labor costs, are well contained”, the Fund argues that “monetary policy should remain firmly on hold” and does not want to rule out the case for further interest rate cuts (IMF 2005, p. 28).

---

## C. Stability and Growth in Developing Countries

### 1. External Financing and Adjustment<sup>15</sup>

#### a. *Resource Gap, Development Finance and Growth*

The economic performance of developing countries depends even more heavily on the global economic environment because of their deep-seated structural and institutional weaknesses. However, there is considerable diversity in the ability of these countries to pursue growth and employment oriented policies, to contribute to global demand, and to respond to external trade and financial shocks. In these respects, the experience of East Asia contrasts sharply with the rest of the developing world. The region as a whole has seen an acceleration of growth in the past two decades as China and a number of newly industrializing economies (NIEs) in South East Asia have followed in the footsteps of the first-tier NIEs in rapid industrialization and development. By contrast, with the exception of a few countries, Latin America, Africa and Middle East have seen a sharp deceleration of growth. In Latin America, GDP per capita has increased by around 5 per cent over the past two decades compared to some 75 per cent during 1960-1980 while in sub-Saharan Africa it has actually fallen by some 15 per cent since 1980 after having increased by more than one-third over the previous two decades.<sup>16</sup>

Differences in growth performance reflect in large part different positions of countries regarding resources gaps, payments constraint and access to external finance. Due to their structural and institutional weaknesses, countries outside East Asia are generally unable to generate adequate domestic resources for rapid accumulation and growth, and face chronic external imbalances and foreign exchange constraints. Low-income countries in sub-Saharan Africa (SSA) and elsewhere do not have access to international capital markets; nor can they attract FDI except where there are rich natural resources. For these countries official development finance remains the only feasible option to fill their resource gaps for a long time to come, until rapid and sustained growth in income starts generating increased domestic resources and attracting private investment.<sup>17</sup> On the other hand, for most emerging-market economies outside Asia, private capital flows do not provide reliable and stable sources of development finance. This includes many middle-income Latin American countries with chronic savings and foreign exchange gaps, weak industrial export bases and excessive debt.

Thus the dilemma is that it is precisely those countries that do not have much need for foreign capital that can attract and sustain relatively large amounts of private finance at reasonable terms. By contrast, countries with large structural savings and foreign exchange gaps debt need substantial and sustained inflows of foreign capital, but they cannot rely on private flows without running into recurrent crises and stop-go development.

The solution to this dilemma requires considerable increase in development aid. Various estimates undertaken by UNCTAD, ECA, World Bank and the Zedillo Commission agree that the current level of aid needs at least to be doubled in order to attain the growth and

<sup>15</sup> Issues taken up in this section are discussed in greater detail in Akyüz (2004b).

<sup>16</sup> See Weisbrot, Naiman and Kim (2001).

<sup>17</sup> For an analysis for Africa along these lines see UNCTAD (2000).

---

poverty reduction objectives agreed in various UN summits.<sup>18</sup> Such financing should be provided by multilateral development banks rather than through bilateral lending, since the latter is driven primarily by political considerations. But, in the past two decades there has barely been any increase in real net flows to developing countries from the World Bank because of declines in net flows from IBRD. More importantly, net transfers (that is, net flows minus interest payments) from the IBRD have been negative in almost every year since 1990, for both low-income and middle-income countries, while net transfers on IDA credits have kept up. Thus, the IBRD has not made any contribution to the financial needs of developing countries as a whole in recent years, other than providing finance to service its outstanding claims.

Another important issue relates to the modalities of multilateral lending. There is a growing agreement that multilateral development finance should be provided to the poorest countries as grants rather than lending. Most of these countries are already highly indebted and in need of a substantial debt write-off, and there is not much to be gained by adding to their stock of debt and interest payments, however concessional they may be. Many middle income countries would need to continue to have access to multilateral development finance in order to overcome their structural and institutional shortcomings. There should, however, be an explicit graduation strategy for such countries from multilateral lending so that resources can be directed to poorer countries.

### ***b. Current Account Financing and Payments Adjustment***

One of the key objectives pursued by the architects of the post-war international monetary system was to avoid destabilising and deflationary adjustment, and trade and exchange restrictions in countries facing temporary balance of payments difficulties. This was seen as essential for steady expansion of global trade and employment and for avoiding the kind of difficulties that had devastated the world economy during the inter-war years. This called for, *inter alia*, provision of adequate amounts of international liquidity at appropriate terms- a task assigned to the IMF.

In view of increased instability of external trading and the financial environment of developing countries, and pro-cyclical behaviour of international financial markets, provision of counter-cyclical current account financing has assumed growing importance in avoiding interruptions to growth and development. However, in this respect, the past sixty years have seen a constant distancing of the IMF from the objectives set in the Bretton Woods Conference. The semi-automaticity sought by the post-war architects in members' drawing on the Fund has been eroded, and through conditionality the Fund has effectively sought to impose exactly the kind of policies that the post-war planners tried to avoid in countries facing temporary payments difficulties - namely, austerity and destabilizing currency adjustments.

Austerity has been promoted in the IMF programmes not only when payments difficulties were due to excessive domestic spending or distortions in the domestic price structure, but also when they resulted from external disturbances such as adverse terms of trade movements, hikes in international interest rates or trade measures introduced against the country concerned. Furthermore, the distinction between temporary and structural disequilibria has in effect disappeared, and the Fund has started to operate on the premise that a developing country should interpret every positive shock as temporary and hence refrain from using it as an opportunity for expansion, and every negative shock as

<sup>18</sup> See UNCTAD (2001, pp. 22-23) for a discussion of these estimates. One of the latest examples for a call to double ODA is found in the so-called Sachs-report (UN Millenium Project 2005).

---

permanent, thus adjusting to it by altering the domestic price structure and lowering growth.

The principal activity of the Fund is no longer lending to countries facing temporary difficulties in their current account payments, but financial bailout operations associated with capital account crises. Such lending is designed not to finance essential payments in the current account, including imports, but to keep countries current on debt servicing to private creditors and to maintain capital account convertibility (see section C.3 below). While most major creditor governments continue to resist proposals for the enlargement of IMF quotas and SDR allocation for increased provision of international liquidity to developing countries facing export shortfalls or rising import bills, they have been willing to support Fund lending, in excess of official limits, to countries facing capital account crises for fear of their adverse repercussions for their creditors and investors.

IMF lending practices need to be reformed. While it should be recognized that money is fungible and in practice it is not always possible to identify the need catered for by a particular loan, it is important to ensure that Fund resources be used to finance current account rather than capital account transactions:

First, IMF lending to emerging markets to counter sharp declines in private capital flows should aim at maintaining imports and economic activity, rather than debt repayment to private creditors and capital account convertibility. There should be strict limits to IMF crisis lending; otherwise it would be difficult to ensure private sector involvement in crisis resolution.

The second area of IMF lending is counter-cyclical support for countries facing temporary payments difficulties in their current accounts due to shortfalls in their export earnings, surges in their import prices or hikes in interest rates on their external debt. Such lending should be available not only to poorer developing countries that have little or no access to international liquidity, but also to emerging markets which normally have access to private finance but often see their access impaired at times of current account difficulties because of pro-cyclical behaviour of markets.

Finally consideration should be given to the creation of a global counter-cyclical facility to be used at times of a sharp downturn in world economic growth and international trade. Suggestions were made for the use of Bank loans for this purpose during the Bretton Woods negotiations, but such a task is better suited for the IMF.

The fundamental point here is that the IMF should limit itself to short-term, counter-cyclical lending for current-account purposes, and there is no sound rationale for the Fund to engage in other forms of lending, including capital account financing or development finance. A restructuring of IMF lending along these lines implies a radical reform that should also address the issue of adequacy of IMF resources. While normal access limits of 100 per cent of quota annually and 300 per cent on a cumulative basis could in principle be observed in IMF lending, it should also be recognized that IMF quotas have lagged behind the growth of global output, trade and financial flows. According to one estimate, adjusting quotas for the growth in world output and trade since 1945 would require them to be raised by three and nine times respectively.<sup>19</sup> A large increase in the IMF quotas would also widen the gold tranche, and help restore the balance between low-conditionality and high-conditionality loans.

<sup>19</sup> See Fischer (1999)

---

## 2. Financial liberalization and the labour market

### *a. Financial and Macroeconomic Instability and Investment*

Both theory and evidence suggest that persistent macroeconomic instability is a main impediment to capital accumulation, employment creation and economic growth in developing countries.<sup>20</sup> Lack of monetary and fiscal discipline has often been seen as the underlying cause of instability in key macroeconomic variables such as the aggregate price level, interest rates, asset prices, exchange rates, budget and current account balances, and the level of economic activity. Large and persistent fiscal deficits and rapid monetary expansion often push these variables to unsustainable levels and lead to rapid inflation. These, in turn, deter capital accumulation and economic growth by creating uncertainty, shortening time horizons and inhibiting the animal spirit of entrepreneurs.

However, it is equally true that monetary and fiscal discipline and price stability are not sufficient for rapid accumulation and growth. Low-income-equilibrium trap is not just a theoretical curiosum but also a historical reality, as observed in many poor countries in SSA and elsewhere. Similarly, one of the major difficulties faced by stabilization and structural adjustment programmes supported by the Bretton Woods Institutions (BWIs) in the past two decades is that success in attaining a reasonable degree of fiscal and monetary discipline and price stability have rarely been followed by a process of rapid and sustained capital accumulation and economic growth.

As already noted, greater monetary discipline and increased price stability have not brought greater financial and macroeconomic stability in industrial countries. This is even more so in the developing world. In many countries in East Asia, asset price bubbles, excessive credit creation and currency appreciations all occurred under conditions of price stability. In the more extreme cases, as in Latin America, price stability has been bought at the expense of financial stability, through exchange-rate-based stabilization programmes, relying on unstable capital flows. Instability in financial markets and financial cycles have generated even greater instability in key macroeconomic variables influencing investment decisions. The outcome is misallocation and misuse of resources as well as decline in the overall level of productive investment.<sup>21</sup>

In East Asia, a high degree of fiscal and monetary discipline, and a tradition of price stability did not spare the region from financial boom-bust cycles and crises. In this region where the investment rate is traditionally high, the impact of financial cycles has been reflected both by fluctuations and misallocation in capital accumulation. In almost all countries hit by the 1997 crisis, there was a sharp upturn in the investment ratio during the boom of the mid-1990s, to be followed by drastic falls after the 1997 crisis. Much of the earlier upturn reflected speculative investment driven by a construction bubble which was exposed with the rapid exit of capital, hikes in interest rates and collapse of the currencies.

In Latin America policies introduced in response to the debt crisis of the 1980s and the acceleration of inflation have left many countries in the region in conditions as fragile as those prevailing in the 1980s, characterised by unstable interest and exchange rates, a high burden of debt, and large and unsustainable current account deficits. Although most countries in the region have succeeded in fighting inflation, and were praised for their

<sup>20</sup> See Fischer (1993), Bleaney (1996), and Elbadawi and Schmidt-Hebbel (1998).

<sup>21</sup> See UNCTAD (2003), chap. IV for the recent experience of developing countries in capital formation; and chap. VI on policy reforms and economic performance in Latin America.

---

macroeconomic policy discipline, they have not been able to harness investment for rapid and stable growth. As inflation has been brought under control, financial instability rather than price instability has become a main obstacle to rapid and sustained capital accumulation, job creation and poverty reduction.

Drastic policy changes introduced in response to the debt crisis and designed to restore macroeconomic stability and correct price distortions by freeing market forces were expected to improve the investment climate and prepare the ground for private-investment-led recoveries, even though it was recognized that some of these measures could cause a temporary investment pause. However, the strategies adopted for activating a dynamic process of capital accumulation and growth have not produced the expected results. Consequently, the investment pause that followed the structural adjustment policies has become a much more permanent feature of the economic landscape in most of the reforming countries in Latin America. The withdrawal of public investment from industry failed to crowd in the private sector, and incentives for private investment have been further eroded by the decline in public infrastructure investment. Furthermore, the conditions that attracted foreign enterprises to Latin America have not been conducive to faster capital formation: FDI as a proportion of GDP was higher in the 1990s compared to the 1980s, but the share of gross fixed capital formation was lower.

A comparison of investment-growth relations suggests a weakening of the effectiveness of investment in Latin America in recent years. Despite extensive market-oriented reforms designed to improve the allocation and use of resources, each percentage point increase in gross capital formation was associated with slower income growth in the 1990s than in the 1960s and 1970s. This reflects, inter alia, a shift to less productive categories of accumulation, such as housing construction. In many countries in the region, private investment in machinery during the 1980s stagnated or declined sharply, before posting modest recoveries in the 1990s.

These trends are no doubt greatly influenced by the instability of overall macroeconomic environment brought about by rapid financial liberalization. This influence has operated in two spheres. On the one hand, large swings in asset prices, interest rates and exchange rates have created short-term, speculative opportunities for large windfall profits, making buying and selling of existing assets more attractive than long-term investment. On the other hand, the very same factors, together with instability in economic activity, have increased the risks of making long-term commitment in illiquid assets. The result has been not only a decline in private capital formation, but also misallocation of investment resources with attendant consequences for employment and wages.

### ***b. Financial Boom-Bust Cycles and the Labour Market***

Financial boom-bust cycles driven by rapid entry and exit of capital to developing countries create serious dislocations and instability in employment and wages. Surges in capital inflows often lead to a deviation of employment and wages from their long-term, sustainable levels while rapid exit of capital and crises result in overshooting in the opposite direction. The recovery process which restores aggregate income to pre-crisis levels generally leads to a wage-employment configuration that is inferior to that prevailing before the outbreak of the crisis. In general, financial cycles in developing countries result in large and durable adverse shifts in wages, employment, income distribution and poverty.<sup>22</sup>

<sup>22</sup> For evidence see UNCTAD (2000), chap. 4.C. and the references therein

---

Surges in capital flows are typically associated with an acceleration of growth, currency appreciation, loss of competitiveness in industry and worsening trade balances. There is often a tendency for real wages to rise alongside currency appreciation, and this can happen even in traded-goods sectors where employment comes under pressure due to increased foreign competition resulting from currency appreciation. All these would be accentuated when capital account liberalization is accompanied by import liberalization.

Surges in capital inflows and financial booms generate forces that tend to shift employment from traded to non-traded goods sectors. However, to the extent that the boom is associated with increased private investment (as in East Asia) rather than consumption (as in Latin America), labour productivity may grow, offsetting the rise in real wages and expanding employment in the traded-goods industries despite the appreciation of the currency. On the other hand, if growth accelerates significantly, then the aggregate level of employment can rise even when employment in traded-goods sectors is falling, because of a rapid expansion in services industries.

The crisis phase is characterised by a generalized fall in wages and employment as the currency comes under intense pressure, interest rates shoot up and economic activity contracts rapidly. Some of the investment undertaken during the financial boom, notably in non-traded sectors, ceases to be viable. Sharp declines in real wages, often associated with rising inflation, fail to check the rise in unemployment, and reduced incomes and employment in organized and informal labour markets become the main social conduit of the adverse impact of financial crises on poverty and equity.

Despite a sharp drop in the currency, exports take time to respond, because of disruptions in lines of credit. Eventually export expansion provides the main stimulus to economic activity, while domestic private investment and consumption follow rather than lead growth. Even when the level of economic activity, as measured by aggregate income, recovers fully to its pre-crisis level, average real wages and particularly the aggregate level of employment typically remain below their pre-crisis levels.

The failure of aggregate level of employment to follow the recovery in GDP is partly due to changes in the sectoral composition of production. As average productivity in industry is typically higher than that in services, the shift in economic activity towards traded-goods industries lowers the employment content of aggregate output. However, for another reason employment and wages lag behind recovery in aggregate output and income. Financial crises inflict serious damage on the balance sheets of enterprises, both in traded-goods and non-traded-goods sectors. Debt and debt servicing rise relative to the value of firms' assets due to the collapse of the currency, hikes in interest rates and distress borrowing. Even as the economic activity recovers, interest and exchange rates are stabilized and credit lines re-established, the health of balance sheets takes time to recover. Firms attempt to raise profits through various means including cuts in wages, labour shedding, increased work effort and rationalization of production processes. As a result, during a recovery from a crisis, productivity and profits tend to rise while wages and employment remain depressed. Increased profits are used to reduce indebtedness rather than for new investment and job creation. Thus, full recovery of aggregate output from a crisis is associated with a partial recovery in employment and wages. In other words, the boom-bust-recovery cycles in emerging markets tend to be highly regressive so far as labour income is concerned. Generally, it takes several years of growth after the recovery before the pre-crisis rates of wages and employment are restored and poverty is reduced to pre-crisis level.<sup>23</sup>

<sup>23</sup> See the discussion in van der Hoeven and Lübker (2005). On lack of rapid progress in reducing poverty during the recovery from the 1997 crisis in East Asia see World Bank (2000a) and (2000b).

---

### 3. Preventing Boom-Bust Cycles and Financial Instability

All these suggest that prevention of boom-bust financial cycles and macroeconomic instability triggered by financial excesses play a key role in improving the conditions of labour in emerging markets. In particular, if costly crises are to be averted, policy needs to pay attention to unsustainable capital inflows and bubbles in domestic financial markets.

However, macroeconomic policy, on its own, is quite powerless in preventing the build up of financial fragility associated with surges in capital flows. The task facing policy makers under such circumstances includes prevention of currency appreciation and unsustainable current account deficits, build up of excessive currency risks and debt in the private sector, and rapid credit expansion.<sup>24</sup> Excess capital inflows need to be sterilized not only because they tend to appreciate the currency but also because they lead to domestic credit expansion and overheating. However, sterilization by issuing government paper leads to higher interest rates, particularly when the surge in capital inflows is large compared to the size of the market for government debt. Although sterilization and higher interest rates tend to restrain domestic credit expansion and private spending, they also encourage arbitrage flows by widening the margin with international rates, making sterilization even more difficult. Furthermore, they entail significant carry costs since interest earned in international markets on reserves fall short of the cost of external borrowing and the rate on government papers.

Less costly ways of sterilization such as raising reserve requirements of banks also face limits. Higher reserve requirements raise the cost of borrowing from domestic banks, discourage intermediation and push the borrowers towards foreign creditors. Banks may also shift business to offshore centres and lend through their affiliates abroad in an effort to benefit from regulatory arbitrage, particularly where foreign presence in the banking sector is important.

Fiscal policy is of little use in dealing with surges in capital flows. Often, the budget constraint is too tight to allow generation of surpluses needed to stabilize the currency and check domestic credit expansion. Besides, in countries where government domestic debt is sizeable and maturities are short, higher interest rates translate into increased public debt service payments, creating pressures on the budget. If maintained long enough, high interest rates can also aggravate the problem of debt sustainability.

Given the constraints faced by monetary policy in managing financial instability and shocks, prudential and capital-account regulations could provide effective mechanisms in dealing with the problems at hand. This they can do in two ways. First, they can prevent excessive risk-taking and build-up of fragility at times of boom and avoid meltdown at times of bust. Second, they can widen the space for monetary policy in managing financial cycles.

However, there are limits to what traditional prudential regulations can do in restraining financial cycles associated with rapid entry and exit of capital in developing countries. Not only are they quite powerless against macroeconomic shocks, but also many of the traditional prudential rules may simply serve to amplify cyclicity, adding to credit expansion and risk taking at times of boom and exacerbating contraction and even leading to credit crunch at times of bust. While counter-cyclical use of prudential regulations noted above (see section B.2) may be useful in containing the damage that may be inflicted by financial crises, they could not adequately deal with risks associated with sharp swings in

<sup>24</sup> For a discussion of this issue see Akyüz (2004a).

---

capital flows and exchange rates. Such risks can be restricted by more stringent application of prudential rules to positions and transactions involving foreign currency, by imposing restrictions on currency mismatches in the banking system and on bank lending in foreign currencies to sectors without foreign exchange earning capacity.

Applied in this fashion, prudential regulations can act as adequate substitutes for capital-account regulations. However, they may not always be able to prevent excessive risk-taking in cross-border borrowing and investment. Thus, better targeted capital-account measures may be needed in order to reduce vulnerability to swings in capital flows and exchange rates. These can also be used in a counter-cyclical manner, tightened or eased according to the underlying conditions. The techniques available for this purpose are well known and were widely used in industrial countries during the 1960s and 1970s.<sup>25</sup>

There is a wide spectrum of capital account regimes in the developing world, but the recent general tendency has been one of rapid liberalization. This is particularly the case in countries with large structural payments deficits, a high degree of dependence on external capital and a heavy debt burden. A controversial issue here is the extent to which the Fund is responsible for premature liberalization in such countries. A recent review by the IMF's Independent Evaluation Unit concludes that the Fund clearly encouraged capital account liberalization during the 1990s. The report suggests that "[f]rom the beginning of the 1990s, the IMF's management, staff, and Executive Board were aware of the potential risks of premature capital account liberalization", but that this awareness "largely remained at the conceptual level and did not lead to operational advice on preconditions, pace, and sequencing until later in the 1990s".<sup>26</sup>

Even though capital account liberalization had not been included in the Washington Consensus, at least in its original form,<sup>27</sup> many of the reforms and objectives sought in that consensus required a large inflow of capital which was not forthcoming from official sources. In particular, capital account opening was found necessary for refinancing the debt inherited from the 1980s as well as meeting mounting trade deficits brought about by rapid trade liberalization.<sup>28</sup> Again, in many countries with a history of failed stabilization programmes, elimination of rapid and persistent inflation would have been impossible without exchange-rate-based stabilization programmes relying on capital inflows. These, together with the prevailing neo-liberal ideology and financial market pressures, including from domestic financial markets, have been the most important factors in pushing many developing countries into rapid financial liberalization. The Fund often supported vigorously trade liberalization and exchange-rate based stabilization programmes, and its staff at very senior levels made substantive contributions to the emergence of a new consensus among Washington-based economists on the benefits of the capital account liberalization, despite the absence of strong theoretical reasons or empirical evidence.<sup>29</sup>

<sup>25</sup> See, e.g. Swoboda (1976).

<sup>26</sup> IMF Independent Evaluation Unit (2005, p. 4).

<sup>27</sup> See Williamson (2003).

<sup>28</sup> See UNCTAD (1999), chaps. IV and V on the link between trade liberalization and capital account opening.

<sup>29</sup> This is acknowledged in report by the IMF IEO (2005, pp. 20ff.). Thus, it was emphatically argued by Fischer (1998) that free capital mobility would generate faster economic growth by promoting an efficient allocation of savings and better diversification of risks. Similarly, according to another senior IMF official, Guitian (1996), big-bang approach to capital account liberalization

---

With few notable exceptions, developing countries have not been willing to restrain short-term, unsustainable capital inflows, and prevent sharp currency appreciations, mounting trade deficits and a rapid build up of external debt even when there were clear signs that such flows were not sustainable.<sup>30</sup> Indeed, generally governments like such booms because they facilitate borrowing and spending, and bring rapid growth. Accordingly there has been a tendency to pursue pro-cyclical fiscal policy at times of surges in capital inflows.

Available evidence suggests that not only did the Fund fail to warn countries against the dangers of premature liberalization generally, but it also chose to ignore the build up of external fragility resulting from short-term capital flows, currency appreciations and unsustainable current account deficits in many emerging markets which subsequently faced devastating crises. On no occasion is the Fund known to have encouraged countries to adopt measures to check short-term capital flows, and it played no part in cases where restrictions were applied over such inflows, as in Chile and Colombia in the form of unremunerated reserve requirements or in Malaysia in 1994 in the form of more direct controls. Although the Board decisions on surveillance required consultations with countries concerned in the presence of unsustainable private capital flows, and introduction and modification of restrictions on or incentives for capital inflows or outflows,<sup>31</sup> there is little evidence to suggest that this task was effectively discharged.

It is true that countries enjoying surges in capital inflows do not always have standby programmes with the Fund and this restricts its ability to influence the policies of its members. Indeed, the Fund's bilateral surveillance is equally ineffective in the case of such non-borrowing developing countries as in the case of its major shareholders. Again, this shows that there is a need to establish effective surveillance mechanisms independent of members' borrowing from the Fund. However, the Fund is also known to have ignored the build up of external fragility in countries pursuing IMF-supported programmes.<sup>32</sup>

Furthermore, maintaining open capital account has been the overwhelming objective of IMF interventions in financial crises in emerging markets. The Fund has shown considerable aversion to the kind of policies adopted by Malaysia in response to the 1997 crisis, including temporary standstills and suspension of convertibility, despite the Board decisions that such measures could be legitimately taken as a last resort in order to prevent financial meltdown and deepening of crises.<sup>33</sup> The Fund's interventions in crises often involved bailout operations designed to keep countries current on their debt repayments to private creditors and to maintain capital account convertibility. Not only do such interventions fail to protect countries against adverse consequences of financial shocks, but they also aggravate market failures by creating creditor moral hazard. They prevent market

was the best way to attain an efficient financial sector.

<sup>30</sup> For instance starting in the early 1990s, UNCTAD constantly warned against potential dangers posed by such capital flows in Latin America; for a summary of the views expressed see UNCTAD (1995, Box 4, pp. 76-77). Warnings were also sounded against the risk of interruption of capital flows to South East Asia before the outbreak of the 1997 crisis: see UNCTAD TDR (1996, pp. 104, 123), and Akyüz (1998b).

<sup>31</sup> See IMF IEO (2005, p. 18).

<sup>32</sup> These include, *inter alia*, Argentina and Russia. The latest example is Turkey which has been pursuing an IMF-supported stabilization programme since 1999. The Turkish economy is now going through an unsustainable boom supported by large inflows of short-term, portfolio capital. The economy shows several signs of build up of financial fragility, including a rapid appreciation of the currency and mounting current account deficits.

<sup>33</sup> See Akyüz (2002).

---

discipline and encourage imprudent lending since private creditors are not made to bear the consequences of the risks they take.<sup>34</sup>

There can be no doubt that correction of such shortcomings in the Fund's approach to capital account regimes requires new arrangements for effective policy surveillance as well as for orderly debt work-out mechanisms. In the former respect the extension of IMF surveillance to "financial sector issues" and "unsustainable flows of private capital" has so far proved ineffective in preventing reoccurrence of crises in emerging markets. In the latter respect, the proposal prepared by the Fund secretariat for Sovereign Debt Restructuring Mechanism (SDRM) has failed to address the issues related to capital account convertibility and excluded mandatory standstills to prevent financial meltdown at times of speculative attacks on currencies. However, even this watered down proposal has been pushed to the back of the agenda of the Fund because of the opposition from Wall Street and the United States.<sup>35</sup>

## **D. Summary and Conclusions**

A number of policy issues need to be addressed both at national and international levels if the world economy is to attain rapid, stable and broadly-based growth, to avoid imbalances and tensions in international economic relations, and to overcome unemployment and poverty:

Policy in industrial countries needs to turn to faster and more stable growth. Reducing unemployment in the context of rapidly growing productivity, wages and incomes should be reinstated as a major objective of macroeconomic policy. Inflation is no longer a major obstacle in attaining this objective.

As a result of rapid liberalization, financial markets rather than labour and product markets have become the main source of macroeconomic instability. Stability and sustainability of growth both in industrial and developing countries now crucially depend on the maintenance of a high degree of financial stability. This calls for a judicious combination of macroeconomic and regulatory tools, including capital account regulations in developing countries.

There is a need to attain consistency in the stance and mix of policies among industrial countries. This is essential for avoiding the emergence of persistent trade imbalances, instability in currency markets and trade conflicts.

Growth- and stability-oriented, sound macroeconomic policies are not sufficient to ensure exchange rate stability. This calls for better governance of international capital flows, and active policies and coordinated intervention designed to maintain reasonably stable and properly aligned exchange rates. Reform of the G3 exchange rate regime holds the key to greater international monetary and financial stability.

The kind of international policy coordination needed to attain these objectives has not been forthcoming. Global arrangements, including IMF surveillance, lack effective mechanisms to provide discipline over policies in countries having the greatest impact on global

<sup>34</sup> For a survey of empirical evidence on the effect of IMF intervention on debtor and creditor incentives see Haldane and Scheibe (2003) who "find concrete evidence of creditor-side moral hazard associated with IMF bail-outs" (p. 1). See also Mina and Martinez-Vazquez (2002) who reach a similar conclusion.

<sup>35</sup> See IMF (2003a) for a brief description of the SDRM and the background information.

---

monetary and financial conditions. It is important to design mechanisms for effective policy surveillance independent of multilateral lending. Ways and means need to be found to make the Fund a genuinely multilateral institution with *de jure* and *de facto* power over the policies of its members, including its creditors and debtors.

A large number of developing countries cannot rely on international capital markets and private capital for adequate and stable finance for development. Increased official financing continues to be the only viable alternative for the foreseeable future. In order to reduce political intervention, such financing should be organized through multilateral rather than bilateral lending.

Multilateral finance should be made available to poorer countries as grants rather than loans. For middle-income countries dependent on external capital, lending by multilateral development banks should be combined with more effective policies to increase domestic savings and investment, and reduce these countries' dependence on external capital. A rapid graduation of such countries from multilateral lending would help to redirect development aid towards the poorest countries.

The IMF should go back to its original mandate in multilateral lending. It should not be involved in financial bail-out operations in emerging market crises or development financing, but focus on providing short-term, counter-cyclical liquidity to developing countries facing temporary payments difficulties. Members should enjoy greater automaticity and face reduced conditionality in drawing on the Fund. Effective discharge of such a function calls for a significant increase in Fund quotas.

The IMF approach to capital account liberalization and international capital flows to developing countries needs a fundamental reform. The Fund should discourage countries from relying on unstable capital flows and help them implement effective regulations and control in checking bubbles. Its crisis intervention should not be governed by a desire to maintain convertibility and debt servicing to private creditors, but to avoid disruptions to economic activity and employment. The Fund should vigorously pursue the issue of establishing effective debt workout mechanisms, including mandatory debt standstills.

---

## References

- Abaroa, P. E. 2004. "The International Investment Position of the United States at Yearend 2003". *Survey of Current Business*, July.
- Akyüz, Y. 1998a. "Inflation Paranoia and Growth Phobia in the Major Industrial Countries", in *Restoring Demand in the World Economy*, ed. by Joseph Halevi and Jean-Marc Fontaine, Edward Elgar, Cheltenham, 1998.
- Akyüz, Y. 2002. "Crisis Management and Burden Sharing". In Yilmaz Akyüz, ed. *Reforming the Global Financial Architecture. Issues and Proposals*. London: Zed Books.
- Akyüz, Y. 1998b. "East Asian Financial Crisis: Back to the Future". In K. S. Jomo (ed.), *Tigers in Trouble*. Zed Books.
- Akyüz, Y. 2004a. "Managing Financial Instability and Shocks in a Globalizing World". *Tun Ismail Ali Lecture*, Kuala Lumpur, February.
- Akyüz, Y. 2004b. "The rationale for Multilateral Lending: A Critical Assessment", Paper prepared for the UNDP Project, Public Finance in a Globalizing World, Geneva.
- BIS. (2001). *71st Annual Report*. Basel. June.
- Bleaney, M.F. 1996. "Macroeconomic Stability, Investment and Growth in Developing Countries". *Journal of Development Economics*, 48, pp. 461-470.
- Bureau of Economic Analysis (2005) U.S. Net International Investment Position at Yearend 2004. Press release dated June 30, 2005. Washington: Bureau of Economic Analysis. <http://www.bea.gov/bea/newsrelarchive/2005/intinv04.pdf>
- Elbadawi, I. and K. Schmidt-Hebbel. 1998. "Macroeconomic Policies, Instability and Growth in the World". *Journal of African Economies*, 7, pp. 116-168.
- Fischer, S. 1993. "The role of Macroeconomic Factors in Growth", *Journal of Monetary Economics*. 32(3), pp. 485-512.
- Fischer, S. 1998. "Capital Account Liberalization and the Role of the IMF". In P. Kenen (ed.) *Should the IMF Pursue Capital Account Convertibility? Essay in International Finance*, No. 207, Princeton University.
- Fischer, S.. 1999. "On the need for an international lender of last resort". *Journal of Economic Perspectives* 13: 23-37.
- Guitian, M. 1996. "The Issue of Capital Account Convertibility: A Gap between Norms and Reality". In S.M. Nsouli and M. Guitian (eds.). *Currency Convertibility in the Middle East and North Africa*. Washington. IMF. pp. 169-188.
- Haldane, Andrew G. and Jörg Scheibe. 2003. "IMF Lending and Creditor Moral Hazard". Mimeo. Bank of England, July.
- IMF Independent Evaluation Office. 2005. *The IMF's Approach to Capital Account Liberalization*. April, Washington, DC.

- 
- IMF. 2003b. *World Economic Outlook*. April, Washington DC.
- IMF. 2003a. *Proposal for a Sovereign Debt Restructuring Mechanism (SDRM)*. A Factsheet. January.
- IMF. 2003c. *World Economic Outlook*. September, Washington DC.
- IMF. 2005. *World Economic Outlook*. April, Washington DC.
- Kindleberger, C. P. 1995. "Asset Inflation and Monetary Policy". *Banco Nazionale del Lavoro Quarterly Review*, (98) 192.
- McCauley, R. N. 2001. "Setting Monetary Policy in East Asia: Goals, Developments and Institutions". Paper presented to the Conference on Financialization and the Global Economy", PERI, University of Massachusetts, Amherst.
- Mina, Wasseem, and Jorge Martinez-Vazquez. 2002. "IMF Lending, Maturity of International Debt and Moral Hazard". Working Paper 03-01. Andrew Young School of Policy Studies.
- OECD. 2005. *OECD Employment Outlook 2005*. Paris.
- OECD. Various years. *Labour Force Statistics*. Paris.
- Pesek, William Jr. 2003. "Bubble Reenters Asia Investors' Lexicon", Bloomberg.com, 22 December.
- Romer, D. 1993. "Openness and Inflation: Theory and Evidence". *Quarterly Journal of Economics*, Vol. 4, November.
- Swoboda, A.K. (ed.). 1976. *Capital Movements and their Control*. Institut Universitaire de Hautes Etudes Internationales. Geneva.
- Tytell, I., and S-J. Wei. 2004. "Does Financial Globalization Induce Better Macroeconomic Policies"? IMF Working Paper WP/04/84.
- UN Millennium Project. 2005. *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*. New York and London: Earthscan.
- UNCTAD. 1995-2003. *Trade and Development Report (various issues)*. Geneva. United Nations.
- UNCTAD. 2000. *Capital Flows and Growth in Africa*. Geneva. United Nations.
- United States Department of Treasury. 2005. *Treasury International Capital System. U.S. External Debt, as of June 30, 2005*. <http://www.treas.gov/tic/>
- van der Hoeven, Rolph and Malte Lübker. 2005. *Financial Openness and Employment: The Need for Coherent International and National Policies*, Geneva, International Labour Office, mimeo.
- Weisbrot, M., R. Naiman, and J. Kim. 2001. *The Emperor Has No Growth: Declining Economic Growth Rates in the Era of Globalization*. Center for Economic and Policy Research Briefing Paper, May.
- Williams, Ian. 2004. *China-US: Double Bubbles in Danger of Colliding*. *Asia Times*, 23 January.

- 
- Williamson, J. 2003. *Did the Washington Consensus Fail?* Institute of International Economics. Washington, DC.
- World Bank. 2000a. *East Asia: From Recovery to Sustained Growth. An Update.* Washington DC. March.
- World Bank. 2000b. *Global Economic Prospects and the Developing Countries.* Washington DC.



---

## Policy Integration Department Working Papers

- No. 1 ILO activities on the social dimension of globalization: Synthesis report
- No. 2 Measuring decent work with statistical indicators – *Richard Anker, Igor Chernyshev, Philippe Egger, Farhad Mehran and Joseph Ritter*
- No. 3 Globalization and decent work: Options for Panama – *Philippe Egger*
- No. 4 Globalización y trabajo decente: Opciones para Panamá – *Philippe Egger*
- No. 5 Indicators of social dialogue: Concepts and measurements – *Lane Kenworthy and Bernhard Kittel*
- No. 6 Assessing the impact of the attacks of 11 September 2001 on women's employment in the United States – *Gertrude Schaffner Goldberg and Helen Lachs Ginsburg*
- No. 7 Decent work and the informal economy in Central America – *Juan Diego Trejos Solórzano and Miguel Del Cid*
- No. 8 Poverty initiatives in the ILO: A review of past and present approaches – *Pat Holden and Dagmar Walter*
- No. 9 Whither the International Standard Classification of Occupations (ISCO-88)? – *Debbie Budlender*
- No. 10 Improving occupational classifications as tools for describing labour markets: A summary of recent national experiences – *Debbie Budlender*
- No. 11 Recent developments in China's labour economy – *Thomas G. Rawski*
- No. 12 The Impact of economic liberalization on employment and wages in India – *Sonia Bhalotra*
- No. 13 The impact of trade liberalization upon inequality in developing countries – *Donald J. Robbins*
- No. 14 The impact of liberalization and globalization on income inequality in developing and transitional economies – *Giovanni Andrea Cornia*
- No. 15 The impact of technology transfer on employment and income distribution in developing countries: A survey of theoretical models and empirical studies – *Mariacristina Piva*

## Policy Integration Department Working Papers prepared for the World Commission on the Social Dimension of Globalization

- No. 16 International finance: Meeting the needs of people in developing countries – *José Guilherme Almeida dos Reis*
- No. 17 The gender dimensions of globalization of production – *Stephanie Barrientos, Naila Kabeer and Naomi Hossain*
- No. 18 Social exclusion in the context of globalization – *Jan Breman*
- No. 19 Gender and globalization: A macroeconomic perspective – *Çağatay Nilüfer and Ertük Korkurt*
- No. 20 Globalization, social exclusion, and work: With special reference to informal employment and gender – *Marilyn Carr and Martha Chen*
- No. 21 Resources for social development – *Antony Clunies Ross*
- No. 22 Does the new international trade regime leave room for industrialization policies in the middle-income countries? – *Alisa DiCaprio and Alice Amsden*
- No. 23 Social dimension of globalization in Latin America: Lessons from Bolivia and Chile – *Ivaro García Hurtado*
- No. 24 The social dimension of globalization: A review of the literature – *Bernhard Gunter and Rolph van der Hoeven*
- No. 25 The social dimension of global production systems: A review of the issues – *Susan Hayter*
- No. 26 Reforming global economic and social governance: A critical review of recent programmatic thinking – *Jeremy Heimans*
- No. 27 Corporate social responsibility: An issues paper – *Michael Hopkins*
- No. 28 Upgrading in global value chains – *John Humphrey*
- No. 29 Implications of globalization and economic restructuring for skills development in Sub-Saharan Africa – *Richard K. Johanson*

- 
- No. 30 The outcome and impact of the main international commissions on development issues – *Frédéric Lapeyre*
- No. 31 Globalization and structural adjustment as a development tool – *Frédéric Lapeyre*
- No. 32 Globalization and perceptions of social inequality – *Malte Lübker*
- No. 33 The changing structure of international trade linked to global production systems: what are the policy implications? – *William Milberg*
- No. 34 Corporate social responsibility: An overview of principles and practice – *Jill Murray*
- No. 35 Inclusive development strategy in an era of globalization – *Ignacy Sachs*
- No. 36 Social consequences of the globalization of the media and communication sector: some strategic considerations – *Seán Ó. Siochrú*
- No. 37 Globalization, history and international migration: A view from Latin America – *Andrés Solimano*
- No. 38 Towards a different kind of globalization, or how the anti-globalists view the world – *Gijsbert van Liemt*

## **Policy Integration Department Working Papers**

- No. 39 How do trade union rights affect trade competitiveness? – *David Kucera and Ritash Sarna*
- No. 40 Statistics on the employment situation of people with disabilities: A compendium of national methodologies – *ILO Bureau of Statistics in collaboration with the In Focus Programme on Skills, Knowledge and Employability*
- No. 41 Employment in the informal economy in the Republic of Moldova – *ILO Bureau of Statistics in collaboration with the Department for Statistics and Sociology of the Republic of Moldova*
- No. 42 Decent work in a least developed country: A critical assessment of the Ethiopia PRSP – *Graeme J. Buckley*
- No. 43 Unemployment and labour market institutions: The failure of the empirical case for deregulation – *Dean Baker, Andrew Glyn, David Howell and John Schmitt*
- No. 44 Women's access to occupations with authority, influence and decision-making power: Women as legislators, senior officials and managers around the world – *Richard Anker*
- No. 45 The world of work in the context of economic integration and trade liberalization – *Daniel Martínez*
- No. 46 Poverty reduction in Pakistan: The strategic impact of macro and employment policies – *Moazam Mahmood*
- No. 47 Trends in work stoppages: A global perspective – *L. J. Perry and Patrick J. Wilson*
- No. 48 Generating decent work for poverty reduction in Cambodia: The voice of workers, employers and the Government – *Moazam Mahmood*
- No. 49 The social dimension of regional integration in ECOWAS – *René Robert*
- No. 50 Measuring trade union rights: A country-level indicator constructed from coding violations recorded in textual sources – *David Kucera*
- No. 51 Patterns of job quality attributes in European Union – *Joseph A. Ritter*
- No. 52 Child labour, education and export performance – *David Kucera and Ritash Sarna*
- No. 53 Measuring the informal economy: From employment in the informal sector to informal employment – *Ralf Hussmanns*
- No. 54 Indicators of labour standards: An overview and comparison – *Richard N. Block*
- No. 55 The pattern of globalization and some implications for the pursuit of social goals – *Gerry Rodgers*
- No. 56 Statistical indicators of social dialogue: A compilation of multiple country databases – *Anne Chataigner*
- No. 57 Trade unions and informal workers' associations in the urban informal economy of Ecuador – *Catherine Vaillancourt-Laflamme*
- No. 58 Decent work, standards and indicators – *Monique Zarka-Martres and Monique Guichard-Kelly*
- No. 59 Social dialogue indicators: Trade union membership and collective bargaining coverage. Statistical concepts, methods and findings – *Sophia Lawrence and Junko Ishikawa*
- No. 60 Informality and gender in Latin America – *María Elena Valenzuela*
- No. 61 Labour developments in dynamic Asia: What do the data show? – *David Kucera and Anne Chataigner*

- 
- No. 62 Sources and Methods: Labour Statistics – Volume 5: Total and economically active population, employment and unemployment (Population censuses), Third edition
- No. 63 Desarrollo local en América Latina: Oportunidades y desafíos para el trabajo decente – *Francisco Alburquerque*
- No. 64 Bangladesh decent work statistical indicators: A fact-finding study – *Mustafa K. Mujeri*
- No. 65 The impact of globalization on poverty in Bangladesh – *S. R. Osmani*
- No. 66 International labour migration from Bangladesh: A decent work perspective – *Tasneem Siddiqui*
- No. 67 Globalization and decent work: A report for the Decent Work Pilot Programme in Bangladesh – *Sukti Dasgupta and Amelita King Dejardin*
- No. 68 East Africa reduction poverty and gender inequality: Selected strategies and issues
- No. 69 Sources et méthodes: statistiques du travail – Volume 5: Population totale et active, emploi et chômage (Recensements de population), Troisième édition
- No. 70 Fuentes y Métodos: Estadísticas del Trabajo – Volumen 5: Población total y económicamente activa, empleo y desempleo (Censos de población ), Tercera edición
- No. 71 The quantification of respect for selected core labour standards: Towards a social development index? – *Ludo Cuyvers and Daniel van den Bulcke*
- No. 72 A new methodology for estimating internationally comparable poverty lines and living wage rates – *Richard Anker*
- No. 73 Issues in macroeconomic and financial policies, stability and growth – *Yilmaz Akyüz*