

Globalization and National Development at the End of the 20th Century

Tensions and Challenges

Andrés Solimano

Do globalization and national development reinforce each other? Are they mutually compatible? What opportunities for national development does globalization open? What problems does it pose? What is the proper balance between national, regional, and global responses to the challenges posed by globalization?



Summary findings

Globalization offers developing countries the opportunities to create wealth through export-led growth, to expand international trade in goods and services, and to gain access to new ideas, technologies, and institutional designs.

But globalization also entails problems and tensions that must be appropriately managed.

For one thing, global business cycles can contribute greatly to macroeconomic volatility at the national level. The scope and severity of crises in Mexico (1994–95), Asia (1997), Russia (1998), and Brazil (1999) suggests the severity of the financial vulnerability developing countries face nowadays.

With financial markets so highly integrated, problems are transmitted rapidly from one country to another. The rapid transmission of financial shocks changes levels of

confidence and affects exchange rates, interest rates, asset prices, and, ultimately, output and employment — with consequent social effects.

Policymakers should also be concerned about how globalization exacerbates job instability and income disparities both within and across countries. Macroeconomic and financial crises, by increasing poverty and social tensions, can be political destabilizing.

As the 20th century ends, the resources of Bretton Woods institutions are strained because of the large and complex rescue packages needed to deal with large-scale volatility. Development policy agendas in the era of globalization need to articulate traditional concerns with growth, stability, and social equity with new themes such as transparency and good governance at several levels: national, regional, and global.

This paper — a product of the Country Management Unit, Colombia, Ecuador, and Venezuela — is part of a larger effort in the region to understand the links between globalization and national development. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Diana Cortijo, room I4-050, telephone 202-458-4005, fax 202-676-0720, Internet address dcortijo@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. The author may be contacted at asolimano@worldbank.org. June 1999. (14 pages)

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AT THE END OF THE 20TH CENTURY**

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Revised

**GLOBALIZATION AND NATIONAL DEVELOPMENT AT THE END OF THE
20TH CENTURY: TENSIONS AND CHALLENGES**

Andrés Solimano*

Globalization and development: do they reinforce? Are they mutually compatible? What are the opportunities opened and the constraints imposed by globalization on the ability to undertake autonomous, national, development? What are the main institutional challenges of globalization? These are questions of first relevance for the coming 21st century. The events of the last two years in the global economy indicates as a main challenge, the seizing the opportunities open by globalization while at the same time managing the tensions and problems it poses particularly, for developing countries. The paper starts sketching the evolution of globalization throughout the 20th century establishing similarities and differences between pre-1914 and late 20th century globalization patterns. We identify the opportunities for wealth creation provided by globalization as well as its 'side effects' in terms of increased financial and macroeconomic volatility and its impact on inequality and job security. Then, the paper discusses the role of global financial institutions in coping with globalization and the

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scope of action for regional and national institutions in a globalized world economy. The paper closes with concluding remarks.

Historical Background

The last decades of the nineteenth century (say from the 1870s) to the early twentieth century (up to 1914) was a period of rapid growth of the global economy based on an expansion of international trade and free capital mobility under the gold-standard. This regime came to an end with the disarray brought about by World War I, which in turn was followed by the big inflations and macroeconomic turbulence of the 1920s in several major European economies and thereafter, by the Great Depression of the 1930s.

These events, in turn, radically reshaped prevailing ideas on how to stabilize global and national economies and the role of international trade and capital movements as engines of growth and prosperity. Global capitalism was seen an inherently unstable system; prone both to periods of volatility and inflation, as in the 1920s, or to recessionary trends without self correcting mechanisms that assure full employment, as it was patently demonstrated in the 1930s.

A new set of global financial institutions emerged in the mid 1940s, known as the Bretton Woods Institutions. The International Monetary Fund was given the mandate of assuring a normal payments system under a system of fixed exchange rates, and providing external financing to countries running balance of payments deficits. The role of the World Bank was to provide long term financing for economic reconstruction and development.

A period of considerable stability, rapid growth and prosperity lasted from the late 1940s to the early 1970s; this period, called the 'golden age of capitalism', was based on

a (globally and nationally) regulated market economy. This regulated market economy could be defined by a myriad of global institutions in charge of providing stability and development assistance, complemented by national institutions such as the 'welfare state', in industrial countries and a 'developmentalist state', in developing countries, oriented to assure social protection and shared growth. The state also was to implement counter-cyclical macroeconomic policies oriented to maintain full employment. The 'golden age of capitalism' ran out of steam in the industrial economies with the two oil price shocks and the ensuing stagflation during the 1970s. Developing countries, in turn, borrowed heavily in the 1970s, a process that led to the debt crisis of the 1980s.

The 1990s have seen reduced fiscal imbalances in some Latin American countries (Argentina, Chile, Mexico) but significant fiscal deficits remain in Brazil, Venezuela, Ecuador. Inflation has declined and a resumption of growth in Latin America took place until 1997, coinciding with the return of capital flows to the region. Nevertheless growth decelerated in 1998 in Latin America (and Asia) and 1999 is expected to be a year of sluggish growth or recession in the region. The 1990s have also experienced recurrent financial instability both of domestic origin and also linked to the global economy. This has been the case of the Mexican crisis of 1994, the Asian crisis of 1997, the Russian crisis of 1998 and the Brazilian crisis of 1999. Globalization, boosted by the adoption of market-oriented economic policies in developing countries and transition economies, is being accompanied by substantial financial volatility characterized by currency crisis of high frequency and intensity, affecting large developing and transition economies.

Interestingly, the global economy of the late 20th century resembles, in several respects, the pre-1914 liberal economic order in the sense of a more open regime for international trade and foreign direct investment and capital movements.

There are, at least, two main differences, however, between pre-1914 and late 20th century globalization. First, the degree of capital mobility in both currency markets and in bonds, equity, short-term credit and other financial instruments is of unprecedented nature in history. Second, in early 20th century globalization, there were not global financial institutions aimed at stabilizing the world economy, financing development, setting global rules for international trade in goods and services (the World Trade Organization), and provide a political and diplomatic forum to settle disputes among states and address a host of other global issues (e.g. nuclear proliferation, climatic changes, poverty, etc) such as the United Nations.

A key question is to what extent this global governance structure largely designed for the economic and political realities of half century ago (albeit some of them self-reforming along this period) are able to face the complex challenges posed by late 20th century globalization.

THE OPPORTUNITIES OF GLOBALIZATION

The economic order of late 20th century offers many opportunities to developing countries and other actors in the global economy. The drastic reductions in barriers to international trade have opened the door for export-led growth. In fact, for small and medium size economies with limited internal markets², the possibilities for rapid

² This is also valid for large economies; in fact, China started to grow at a faster pace since 1977-78, after it stimulated export-oriented growth and foreign direct investment.

economic growth lie, to a large extent, in production oriented towards international markets. The historical experience of the last three decades shows that countries that have managed to grow at very rapid rates, say 7%, 8% or more per year, have all relied on strong export growth, with exports expanding at a faster rate than GDP. This has been the case of East Asia since the 1960s (up to their current crisis), China, since the mid 1970s, Chile since the mid 1980s and others.

Globalization creates, through export-led expansion, the potential of rapid overall output growth, increasing national wealth and contributing to improve living standards in developing countries.

Another benefit of globalization is the access to a wide variety of consumption goods, new technologies and knowledge. Globalization allows the access to ideas and international best practices in different fields and realms: This can be a new product design, a new investment project, a new production technology, a new managerial practice, it can even be a certain set of institutions that has proved successful in other places, and, eventually, a model of society.

Of course the mere acquisition or imitation of foreign products, technologies or foreign social models to local conditions with all their specificities and idiosyncratic features is not a guarantee of success. It is just a potential benefit (or cost if used in misleading fashion) derived from broadening the set of choices open to the participants of the global economy.

TENSIONS AND DILEMMAS OF GLOBALIZATION

Globalization also poses tensions and dilemmas to countries integrated to the world economy.

One tension of globalization associated with the fact that in a more interdependent and inter-linked world economy any adverse global or regional shock, for example the Asian and Russian crisis of 1997-98, is rapidly propagated to other economies. The propagation (contagion) mechanisms at work can be a decline in the import volumes and/or changes in the real price of commodities (oil, copper, timber, etc). Economies that depend heavily on a few main commodities as their main source of export earnings and fiscal revenues can be hit hard by these shocks. This has been the case of Mexico, Indonesia, Ecuador, Venezuela and Russia with the drop in oil prices, and Chile with the decline in copper prices, to give some examples. Another transmission mechanism is asset markets. Highly integrated financial markets tend to transmit global, regional or local shocks much more rapidly than in past decades when financial markets were less integrated. Portfolio shifts affect exchange rates, interest rates and economic activity. As the volumes of financial intermediation and currency transactions are enormous nowadays, shocks can be greatly amplified in more or less synchronized fashion with destabilizing effects on many economies. This source of financial volatility was largely absent in the world of the 1950s, 1960s and early 1970s when multilateral lending, aid and foreign direct investment dominated global capital movements.

There is ample empirical evidence showing that uncertainty and volatility penalize capital formation (and productivity growth) with adverse effects on economic growth. Thus instability and volatility can be ultimately viewed as a tax on growth and prosperity. In many instances, this instability originates from abroad. However, the quality of the domestic policy response in the face of adverse external shocks matters. The nature and timing of the domestic policy response can soften or increase the impact of these shocks.

Another tension of globalization lies in its social effects. As globalization is often associated with increased instability of output and employment, this affects, among other things, job security. As labor income is the main source of earnings for the majority of population under capitalism, job insecurity is socially disruptive and brings tensions to the fabric of society. In addition, flexibility in labor markets required to compete, successfully, in international markets, tends to erode long term work and personal relationships between firms and employees, workers and managers that traditionally give a sense of security to people. Another open discussion is whether foreign trade and globalization narrow or widen income disparities. Traditional trade theory suggesting factor price equalization across countries seem of little relevance in a world of large per capita income differentials (e. g. between say Sub-Saharan Africa and the OECD); moreover, convergence in income levels (per person) is, at least, very weak across regions and nations.

In addition, globalization gives a premium to people with sophisticated skills, high levels of education, and entrepreneurial traits. These are people better equipped to survive and succeed in the more competitive world brought about by globalization. The mirror image of this is that unskilled labor, uneducated workers and marginalized population are likely to benefit less in a more competitive world economy.

Thus income and wealth inequality can be amplified, underscoring the need for public policy to correct these inegalitarian trends.

Another critique of globalization is that it tends to transmit the cultural patterns of large countries to the rest of the world through imitation of consumption patterns, global

mass media and other means of influence. This trend would, eventually, lead to homogenization of values, thereby reducing cultural diversity and national identities.

GLOBALIZATION AND THE LIMITS FOR COUNTER-CYCLICAL POLICY

Globalization is seen as a disciplinary force for governments that undertake unsustainable economic policies. High fiscal deficits and unsound financial policies that lead to inflationary pressures, current account deficits and/or high real interest rates, sooner or later, tend to be penalized by international investors and global capital markets. The room for populist and/or unsustainable policies is much narrower in a globalized world. However, the other side of this is that fiscal policy tends to lose its capacity to act as a counter cyclical instrument oriented to maintain full employment. The fact is that international financial markets are very sensitive on the stance of fiscal policy of a country and uses it as an indicator of the degree of 'macroeconomic responsibility' of governments. This, tend to encourage governments to follow persistently austere fiscal policies in order to satisfy financial markets and gain credentials of serious fiscal behavior. In some sense this is fine but it is also important to recognize that it induces governments to undertake pro-cyclical fiscal policies cutting fiscal spending or rising taxes in downturns, amplifying an economic slowdown or a recession with the ensuing loss in employment and real income. The 'classical' role of fiscal policy to maintain a high level of aggregate demand when private investment or private consumption declines is substituted by restrictive fiscal policy oriented to gain credibility and induce a recovery only through a reactivation of private spending.

INSTITUTIONAL CHALLENGES OF GLOBALIZATION

The institutional architecture of the late 20th century is facing important challenges from globalization. Let's mention some of them:

First, it is increasingly recognized today that the maintenance of global financial stability is becoming a very complex task. Capital moves very fast across national boundaries responding to changes in relative asset returns, flows of information about investment opportunities and changes in national economic policies. Traditional instruments of monetary and financial control are, thus, less effective in this setting.

Second, as the Mexican, Asian and Russian crisis show, the magnitude of current external imbalances to be financed (and the outstanding financial liabilities to be served) in crisis situations are of such magnitude that strain (or even exceed) the existing resources available by the IMF and other multinational lending institutions, that have to prepare, in short time, emergency loans of an unprecedented size. Rescue packages of 10, 20, 30 billions dollars (or more) towards countries, before or after suffering speculative attacks on their currencies, are not uncommon nowadays.

Third, international financial institutions (IFISs) have serious problems to anticipate macro and financial crisis. Moreover, when the crisis take place and the IFI's come with rescue packages they create a moral hazard problem by giving, implicitly, incentives to market participants for excessive risk-taking in the anticipation of future bail-outs.

Fourth, the exact dividing lines between balance of payments financing (the realm of the IMF) and development lending (the scope of multilateral developments banks) have become less clear. This was already the case in the 1980s when both Bretton

Woods institutions started to lend in tandem for balance of payments support as private financing dried-up, as a consequence of the debt crisis. Again in the 1990s meeting the large external financial needs associated with the Mexican, Asian, Russian and Brazilian crises require a combination of balance of payments and development financing.

Some institutional failures are also market failures. For example, the failure to anticipate financial crisis not only affect public multilateral institutions but also market participants and international private risk-grading agencies (the later even tend to aggravate confidence crisis when they downgrade countries in the midst of a crisis).

Moreover, the costs of financial crisis are large and affect creditors as well. Relentless lending behavior is costly even with massive rescue packages. In addition, as the current Russians crisis show the effects of letting the market alone to arrange crisis situations without public intervention can be very disruptive.

Coming back to the institutional issue a strategic question is how to manage the negative side effects of globalization, particularly the exacerbation of volatility at national and international level? This is a complex subject well under discussion now, although some observations are in order here:

First, there is a need to recognize that free trade and financial integration, two key dimensions of globalization are different in terms of their respective contribution to economic stability, growth and social welfare. Crisis of the 1990s show that volatility of short term capital flows lead to large fluctuations in real exchange rates, and real interest rates, affecting adversely the real side of the economy, e.g. trade flows investment, output and employment. The implications of this for capital account liberalization needs reassessment. It is different to open for foreign direct investments that often bring

technology, know how and physical capital than full liberalization of short term capital flows that are generally more volatile and unpredictable.

Second, there is a need to strengthen macroeconomic policy consultation and coordination among emerging market economies suffering the effects of exacerbated volatility from abroad. There is not an equivalent to the G-7 or G-10 at the level of developing countries and transition economies. Collective action at the level of poor and middle income countries is lacking.

Third, it is necessary to enforcing the Basle Capital accord of 1998, signed by over 100 countries, that recommends core principles of bank lending, reserves, transparency and others. This should be complemented with appropriate mechanisms of bank's surveillance, and reporting of relevant information for both banks and corporations.

Fourth, there is need of a clear definition of the resources available to IMF to enable it to perform its role when the liquidity needs of its member countries during periods of crisis have increased enormously.

Fifth, there is need to establish clear exit, liquidation and bankruptcy rules in countries affected by liquidity, or solvency crisis; that are well known and accepted by debtors and creditors alike.

Sixth, exchange rate-regimes need to be reexamined in a world of capital mobility. Flexible exchange rates, currency board and monetary unions are being considered now as better alternatives than fixed exchange rates and bands. However, it is useful to remind that exchange rate regimes need to be discussed along with other policy fundamentals.

Last, but not least, there is need for a fresh look at the content of the matrix of policy dialogue and conditionality of the international financial institutions that fits suit to the era of globalization. This range from a careful consideration of the degree of fiscal austerity in adjustment programs avoiding unnecessary recessionary programs that can be socially destabilizing by increasing unemployment and poverty. Also, policy conditionality now extends to the domestic banking system and includes issues of transparency and governance that are of a complex nature and politically sensitive.

THE OTHER SIDE OF GLOBAL GOVERNANCE: REGIONAL AND NATIONAL INSTITUTIONS

Global problems require responses at global, regional and national levels. At institutional level, for developing countries, globalization has been accompanied a double movement: a) the emergence as relevant actors, besides of the Bretton Woods Institutions both in terms of volume of financing and policy advice, of Regional Development Banks, (e.g. IADB, EBRD, ADB, AFDB) and b) a reduced role of national governments in conducting autonomous economic policies.

Regional institutions often have informational advantages about regional economic, political and cultural realities that matter for the development impact of projects and the political feasibility of the policy advice given by global institutions. In addition, there is greater country representation of developing countries in the most important decision-making bodies (Board of Governors and Board of Directors) of the regional institutions than in global institutions. In contrast, regional development institutions are less exposed to global best practices and knowledge than global institutions.

The nation-state is still of decisive importance as source of legitimacy in spite of their reduced direct economic effectiveness in a globalized world. In fact, regional and global institutions are ultimately 'owned' by national governments. In other words, they are the 'agents' that implement the mandates of the 'principal' (the national governments). Of course, these mandates are filtered by the bureaucratic structures of the regional and global institutions and (at least in the IFIs), these mandates carry an influence that is proportional to reflect the respective voting power of individual countries; in turn, a direct function of their economic importance in the world (or regional) economy.

Issues of representation, effectiveness and implementation of developing countries mandates are at the core of effective global and regional governance.

CONCLUDING REMARKS

This paper reviews opportunities opened by globalization to developing countries but also identifies the dilemmas and tensions it poses.

The main opportunities of globalization for developing countries lie in the potential for wealth-creation through export led growth and the benefits of expanded international trade of goods, services, access to new technologies, ideas, institutional designs in the global market place.

However, globalization brings along also serious problems and tensions that need to be managed in appropriate ways. Global business cycles give rise to considerable macroeconomic volatility at the national level. Of course, volatility has been observed for a long while in developing countries but has become more acute in late 20th century

globalization. In particular, the scope and severity of the crisis of the 1990s, say in Mexico (1994-95), Asia (1997), Russia (1998), Brazil (1999) is evidence that we are facing severe financial vulnerability. This is a very serious problem of globalization as highly integrated financial markets transmit, very quickly, across countries, financial shocks and change in confidence levels that affect exchange rates interest rates, asset prices and ultimately output and employment with adverse social effects.

The effects of globalization on income distribution and social differentiation is another area of policy concern, as globalization along with technological progress might exacerbate instability of employment and, eventually, widen income disparities both within and across countries. More dramatically, the severe macro/financial crisis of the era of globalization often lead to increases in poverty and social tensions that can be politically destabilizing. This paper also discusses the challenge for global financial institutions (the Bretton Woods Institutions) of coping with globalization. Nowadays, these institutions have to deal with large scale volatility associated with globalization, their resources are strained by the size of the rescue packages and the problems of stabilization are more complex due to the financial and social ramifications of the crisis. In addition, new complex themes have crept their agendas such as anticorruption, good governance and transparency. Finally, a theme that deserves further attention is the need to strike a proper balance between global, regional and national institutional responses to the challenges posed by globalization.

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