Policy challenges of Economic Globalisation

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Introduction

Globalisation can be described as a dynamic process that links the economy of a nation with the world economy through economic and non-economic forces. In this paper I shall confine myself to the economic forces of globalisation and in particular to cross-border capital flows. The process of globalisation has its origins in antiquity but recent innovations in information and communications technology has speeded up the process and also heated up the controversies surrounding the costs and benefits of globalisation.

In this paper I propose to use some well tested simple economic models to examine in a cool manner some of the hot topics of economic globalisation. Economists have a remarkable propensity to disagree among themselves and this came to the attention of the literary icon Bernard Shaw and irked a US president demanded advice from the non-existent one-handed economist. Well economists disagree because there are many good ways to skin a cat. Economists use models to analyse complex problems and give answers that may be technically correct. But just like the answer given to the hot-air balloonists who got lost and asked directions, the answers may be technically correct but not operational (a famous joke about economists). To make the answers operational it is necessary to interpret the answers in the light of country specifics.

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I. Introduction.

Globalisation can be described as a dynamic process that links the economy of a nation with the world economy through economic and non-economic forces. In this paper I shall confine myself to the economic forces of globalisation and in particular to cross-border capital flows. The process of globalisation has its origins in antiquity but recent innovations in information and communications technology has speeded up the process and also heated up the controversies surrounding the costs and benefits of globalisation.

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The paper is structured as follows: Section I briefly reviews the free market ideology embodied in Washington Consensus policies advocated by pro-globalisers. Section II provides an operational definition of economic globalisation. Section III reviews a major force in globalisation -trade liberalisation through the prism of trade theoretic models. Section IV explains using a gravity model how revolutionary changes in information technology have turbo charged the globalisation process recently. Section V presents the pro-globalisers' case for capital account liberalisation drawing on the logic of the neoclassical growth model. Section VI reviews the mechanics of how capital flow reversals precipitate financial crises under globalisation. Section VII policy measures advocated to combat financial crises at the national level. Section VIII discusses some proposals for reshaping the international financial architecture. Section IX discusses some challenging macroeconomic policy design issues facing globalising economies like Sri Lanka. Section X concludes the paper.

The process of globalisation has recently been mentored the so called Washington Consensus policies or the free market ideology enunciated by a trio of institutions located in Washington: The International Monetary Fund (IMF), The World Bank and the US Treasury (Stiglitz 2006). Developing countries the Washington Consensus free market policies in order to qualify for adjustment assistance needed to tide over economic crises. These free market policies involve: trade liberalisation (reduction of tariff and non-tariff barriers on trade in goods and services), privatisation (sale of state-owned enterprises to the private sector), deregulation (removal of controls over businesses), capital account liberalisation (removal of restrictions on cross-border capital mobility).

Anti-globalisers allege that aim of the Washington Consensus policies is to spread free market capitalism in developing economies. Free market policies are based on the belief that the price-mechanism or Adam Smith's 'invisible hand' will allocate scarce resources efficiently, maximise growth which would trickle down to the masses increasing their welfare. Anti-globalisers contend that free market policies or the invisible hand does not work in developing countries because of market failure due to incomplete markets and imperfect information. Therefore, anti-globalisers perceive that government intervention has a role to

play in the efficient allocation of resources because the malfunctioning of the invisible hand or the price mechanism.

II. A definition of economic globalization.

Globalization is an on-going multi-dimensional dynamic process that integrates the domestic economy with the international economy through economic and non-economic forces. In this paper I confine myself to a review of the major economic forces of globalisation as listed below:

1. Trade liberalization.
2. Technology transfer.
3. Capital flows.

There are, of course, other important economic forces such migration and non-economic forces such as environmental degradation and global warming, cultural homogenisation, political globalisation and the spread of terrorism, which are not discussed in this paper but dealt with elsewhere (Bhagwati 2004). In the discussion of economic globalisation I have focussed attention mainly on capital mobility as it is the major force driving economic globalisation currently.

Globalization is not a new process its origins are lost in antiquity. The first phase of globalisation or Globalisation Mark I was spearheaded by the nation state. At the end of World War II Globalisation Mark II was propelled mainly by the emergence Multinational Corporations (MNCs). Globalisation Mark III, the current phase of globalisation is propelled by the revolutionary changes in information technology (IT). The IT revolution has turbo charged cross border capital flows and these capital flows are at the centre of financial crises that have rocked the world economy in recent times. In the sequel the various forces that underpin the process of economic globalisation will be critically reviewed using some rudimentary economic models.

III. Trade liberalisation

Trade liberalisation or the removal of tariff and non-tariff barriers is one of the major forces driving economic integration of nations or globalisation. The pure theory of international trade establishes analytically that free trade is best because it maximises national and global welfare. David Ricardo (1817) used the logic of a simple two-country, two-good, one-factor (2x2x1) model to demonstrate that a country by specialising in the production for export the good in which had a comparative advantage (that is the good the country could produce relatively cheaply) and import the other good, the country could maximise national welfare (consumption of both goods). Simultaneously the other country also maximise its national welfare and in the two country world economy global welfare would be maximised.

Extending the trade model to two factors instead of one as in the case of the Ricardian model, the factor endowments (Heckscher-Ohlin) model and explain that the good that uses intensively the relatively abundant factor becomes the comparative advantage good. By exporting the comparative advantage good and importing the other good both countries can maximise national and global welfare as before. The factor endowment model shows that free trade makes the owners of the factor that uses the factor intensively in the export good gain while the owners of the other factor lose because of free trade. Therefore, free trade creates potential winners and losers. Unless suitable policies are implemented to redistribute income from potential gainers to losers, free trade could increase income inequality and give rise to social and economic tensions (Samuelson 1962).

The above free trade models clearly confirm that free trade is a positive-sum-game as it maximises national and international welfare. But we find that world trade is restricted by protection through the imposition of tariffs, quotas and subsidies. Trade models demonstrate that protectionist measures would be welfare eroding but nonetheless they are widespread in the real world. The political economy of trade shows that this is because ‘special interest’ groups like the farm and steel lobbies succeed in enhancing their welfare at the expense of national welfare through collective action (Krugman and Obstfeld 2006).

The World Trade Organisation (WTO) has attempted to promote globalization through trade liberalisation by engaging in successive rounds of Multilateral Trade Negotiations (MTNs). The current of MTN, the 9th round or the Doha round is currently deadlocked because advanced countries (US, Europe, Japan) have shown a reluctance to scale down the massive farm subsidies that are given to some agricultural goods in which developing countries enjoy a comparative advantage (i.e. can produce relatively cheaply). The political economy of free trade shows that advance countries while engaging in the rhetoric of free trade fail to reduce protection because they pander to demands of special interest groups as these groups contribute to the re-election maximising strategies of incumbent governments.

Developing countries like Sri Lanka also pursued protectionist policies in the mid-1960s to promote infant industries under a strategy of Import Substituting industrialisation (ISI). The ISI policies were ill-designed and attempted to produce through state owned enterprises goods for the domestic market replacing imports. These ISI industries did not have a comparative advantage and were uncompetitive in the world market and doomed to fail. About the same time a group of High Performance Asian Economies (HPAEs) had adopted the strategy of Export Oriented Industrialisation (EOI) where production was geared for export to the world market. The EOI strategy delivered spectacular growth rates to the HPAEs and they were hailed as the Asian Miracle economies (World Bank 1993).

When Sri Lanka obtained political independence in 1948, in per capita income terms Sri Lanka was far ahead of the Asian Miracle economies. But the pursuit of protectionist policies pushed the economy to a slow growth locus. However in 1977 when Sri Lanka adopted the EOI strategy they economy switched on to a fast growth locus and growth and per capita income increased dramatically. The EOI policies adopted in Sri Lanka transformed the economy from a plantation economy to a manufactures export economy or from a “banana republic to a pyjama republic”. The spectacular increase in per capita income or welfare was accompanied by increasing income inequality or the widening gap between the rich and poor as predicted by the trade models, because of the failure to implement effective redistribution policies. The widening income inequality gave rise to civil unrest and increased ethnic tensions.

The biggest blow to the policies of globalisation through trade liberalisation strategies was delivered in mid-1998, not by Sri Lanka, but by the spectacular collapse of the much panegyrised Asian miracle economies. The miracle Asian economies were devastated by a series of financial crises due to the sudden reversal of short-term capital inflows. Overnight the Asian miracle economies were transformed into debacle economies. The crisis contagion from the debacle Asian economies rapidly spread worldwide threatening the stability the global financial system. The sudden collapse of the Asian miracle due to the reversal of capital inflows raised serious doubts about the wisdom capital account liberalisation advocated by the Washington Consensus policies.

The next section reviews the role played by the information technology revolution in galvanising both the globalisation process and cross-border capital mobility.

IV. Information technology revolution

The information technology (IT) revolution got turbo-charged over the past couple of decades because of the convergence of innovations in tele-matics (computers, satellite, fibre optic) technologies. These IT innovations resulted in dramatic reductions in the costs of transport and telecommunications, thereby overcoming the 'tyranny of distance' or 'flattening the world' (Friedman 2006). The gravity model demonstrates how the IT revolution by reducing the tyranny of distance bolstered the trade in goods and assets between national economies, strengthening the globalisation process. The gravity model postulates that the trade between two countries is directly related to the size of their output or GDP and inversely related to the distance between the two countries. When the cost of transport and communications falls, the distance between the two countries falls resulting in an increase in the trade between the two countries. In symbols the above predictions can be stylised by the gravity model as follows:

$T_{ij} = Y_iY_j/D_{ij}$; where Y_i: GDP country i , Y_i: GDP country j,

T_{ij}: Trade between country i & j, D_{ij}: Distance between country i & j.

The widespread adoption of the new IT flattened the world and facilitated the computerisation and robotification of production leading to the emergence of the 'new economy' in countries like the USA and Australia (Karunaratne 2006a).

The IT revolution unleashed 10 forces to flatten the world: the fall of the Berlin wall and opening of Windows, the world-wide web, workflow software, uploading, outsourcing, offshoring, supply-chaining, in- forming and the steroid of digitising and transmission of value-laden information (text, voice, and image) at low cost and high speed regardless of distance (Friedman 2006). The overcoming of the tyranny of distance and establishment of a seamless world by the new connectivity delivered by the IT revolution speeded up the globalisation process. It empowered both corporations and individuals to collaborate in new forms of trading activities such as e-commerce, e-business, tele-conferencing, tele-marketing, etc., galvanising the process of globalisation.

However, anti-globalisers despair that the new plug-and-play world delivered by the IT revolution has not enhanced the living conditions of 80 percent of the world population that lives in the developing countries on less that 2 US dollars a day (the World Bank definition of poverty). The anti-globalisers allege that the IT revolution has exacerbated the digital divide or the gap between the information rich and information poor. They point out that except for a few isolated episodes like the use of mobile phones by the Grameen banks in Bangladesh to deliver micro-credit to women the potential to harness the new IT to upgrade the delivery of education, health and medical services to the poor remains untapped. The IT revolution has enabled big business and MNCs to increase cross-border capital flows or the trade in assets to new heights.

V. Capital mobility.

The most potent force currently driving economic globalisation is not trade liberalisation or the IT revolution but capital mobility. Yet the strength of cross-border capital flows when measured by metrics such as: interest parity conditions, savings investment correlations (Feldstein and Horioka 1980), exchange rate volatility (Meese and Rogoff 1983), is way below its maximum potential. Capital mobility still has latent potential waiting to be harnessed for growth and development.

Capital flows from relatively capital abundant advance economies to capital scarce developing economies occur because it facilitates the diversification of asset portfolios resulting in the maximising of returns and the minimising of risks. Portfolio diversification minimises risks by 'not putting all your eggs in one basket'. The capital inflows from advance

to developing countries can boost the national saving rate and increase the per capita income or standard of living permanently and the growth rate temporarily as predicted by the neoclassical growth model (Solow 1956). Therefore capital flows by increasing growth has the potential to increase the welfare of 80 per cent of the world's population that lives in developing countries. It should be noted that the Washington Consensus policies that advocate capital account liberalisation has the imprimatur of the neoclassical growth model. However, when pro and anti-globalisers clash over the costs and benefits of capital account liberalisation often they do not clarify what type of capital flows they are referring and therefore they produce more heat than light.

Broadly speaking capital flows from advance to developing countries can be classified into two types: short-term and long-term capital flows. Short-term capital flows are mainly debt financed, while long-term capital flows are equity finance or Foreign Direct Investment (FDI). Short-term capital flows are hot money that flows in and in search of quick speculative profits. While long-term capital flows in the shape equity or FDI brings in its train the much sought after magic package of technology, managerial and marketing skills. Short-term capital flows and long-term capital flows are like good and bad cholesterol and both pro and anti-globalisers agree that long-term capital flows can play a vital role in promoting growth and improving per capita as predicted by the Solow growth model. But short-term capital flows are reversible and wreak economic havoc and these flows are the whipping boy of anti-globalisers.

The Solow growth accounting equation (Mankiw 2007) has been empirically validated for some of miracle Asian economies and the results reveal that growth was fuelled by the increase in factor inputs or perspiration rather than by the increase of total factor productivity or inspiration. Therefore, it was conjectured that the Asian economic miracle would peter out because of the operation of the law of diminishing returns (Young 1995, Krugman 1994). However, in retrospect, the Asian economic miracle was shattered in mid-1997 not by the law of diminishing returns but by the sudden reversal of short-term capital inflows. The reversal of capital flows engulfed the Asian economies in a full-blown financial crisis and the crisis contagion spread rapidly across the world threatening the stability of the global financial system. The causes and mechanics underpinning the various financial crises that rocked the economies and stifled the globalisation process have been stylised in a few key models which are briefly reviewed in the next section.

VI. Models of financial crises

Globalisation and the cross-border hyper mobility of capital have increased the vulnerability of open economies to financial crises caused by the sudden reversal of speculative short-term capital flows. Three key models of financial crises arising from speculative attacks and collapse of the currency peg are stylised based on country experiences over the past three decades.

The *first-generation models are* based on the experience financial crises that ravaged some Latin American economies and the mechanics are stylised in a canonical model speculative attack model (Krugman 1979). The crisis occurred in these Latin American economies because of increase in the budget deficits caused by expansionary fiscal policy. The budget deficits had to be financed by running down foreign exchange reserves. The depletion of reserves triggered a speculative attack causing the collapse of the currency peg, unleashing a full-blown financial and banking crisis and economic disruption.

The *second-generation models* are based on the experience of the malfunctioning of the European Exchange Rate Mechanism (ERM). The origin of the financial crisis is not linked to bad macroeconomic policies and weakening of fundamentals, but rather to sudden changes in market psychology resulting in panic and herd behaviour causing rapid capital flight or an

outflow of short-term capital (Diamond and Dybvig 1983). Capital outflow depleted foreign exchange reserves and brought about a speculative attack on the currency peg. These models exhibited multiple equilibria and demonstrated that the lack of credible monetary policy providing the incentive for speculators to launch their attack on the currency, precipitating a financial crisis (Obstfeld 1996).

The *third-generation models* based on the experience of the Asian financial crisis attributes a key role to moral hazard behaviour by foreign creditors who under implicit guarantees lend to domestic financial intermediaries. The domestic financial intermediaries in the absence of prudential regulation re-lend to crony capitalists who invest in risky projects that eventually go belly-up. When this occurs the foreign creditors panic and refuse to rollover their loans triggering a massive capital inflow reversal which exhausts foreign exchange reserves and precipitates a full-blown financial crisis (Sarno and Taylor 2002, Krugman 1998). It is noteworthy in all the different models the sudden reversal of short-term capital inflows is the main villain behind the devastating financial crises.

The next two sections of the paper discuss the policies aimed at reducing the vulnerability of the globalising economy to financial crises at the national and international levels, respectively.

VII. National level crisis prevention policies.

After the Asian crisis the wisdom of liberalising the capital account as recommended by the Washington Consensus policies became the focal point on the debate on globalisation. Countries like India and China pursued gradualist policies of capital account liberalisation and appear to have avoided serious financial crises that engulfed Russia and Argentina that opened capital account following a cold-turkey approach bringing in its wake economic turmoil. The sequel enumerates some policy initiatives that could be undertaken at the national level to minimise the vulnerability to financial crises due to sudden capital flow reversals.

1. Develop sound banking and financial institutions so that prudential supervision and regulation, transparency and good governance will minimise moral hazard behaviour and risky borrowing by crony capitalists.
2. Sequence the liberalisation of the capital account after the establishment of sound banking and financial institutions. An follow a gradualist rather than a cold-turkey approach to opening the capital account, giving policymakers the chance to take corrective action or ‘throw sand on the wheels of international finance’ if and when it becomes hyperactive.
3. Reduce the vulnerability to liquidity/rollover risk and balance sheet risk. This requires that policymakers monitor appropriate short-term debt to foreign exchange reserve ratios rather than short-term debt to import ratios. Both maturity mismatch and currency mismatches between debts and return from investments that trigger financial crises should be averted.
4. Support policies that nurture the establishment a climate conducive to business investment and therefore long-term capital inflow (FDI). This involves support for policies that uphold the rule of law, property rights and political stability.
5. Meet Basle Accord capital adequacy ratios designed minimise credit and market risks. Here the regulators aim to ensure that there is sufficient amount capital relative to outstanding loans.

Anti-globalisers are critical about the stabilising effects achieving short-term debt to reserve ratio of unity. Because this generates reverse capital flows that benefits the lending nation and inflicting growth retarding losses on the borrowing nation. The following numerical

example illustrates the operation of these adverse flow mechanics. If a nation borrows $100 million at an interest rate of 10% from USA to meet the requirements of short-term debt to reserve ration, there should be a back with $100 million reserves which could be in form US T-bills that earn 5%. The net effect of this transaction is a reverse flow of $5 million to USA. The opportunity cost of this capital outflow is much greater than $5 million as this money could have been spent development projects in education, medical and health care.

Anti-globalisers also contend that Basle type capital adequacy of debt to total debt ratios creates a bias towards riskier short-term borrowing than long-term borrowing. Such short-term borrowing can result in bank runs if the lenders panic and decide to pull out their money simultaneously.

The increase securitisation (repackaging of bank assets into more marketable forms by nonbank institutions) also poses challenges for effective prudential and thus underscores the need to encourage long-term rather than short-term capital flows.

VIII. Proposals for reshaping the international financial architecture.

The Asian economic crisis also led to proposals for a radical reshaping of the international financial architecture rather than just tinkering at the edges by improving transparency, surveillance and corporate governance. Some of the proposals are enumerated below:

1. It has been argued that the IMF which was designed to offer assistance to member nations to tide over temporary balance of payments crises was geared to implement stabilisation policies. The IMF was not institutionally geared to formulate policies to tackle systemic breakdowns. The short-term pro-cyclical policies implemented by the IMF worsened the economic travails of crisis ravaged economies. The repeated policy mistakes by the IMF have led anti-globalisers to call for its abolition.
2. The IMF not only erred in prescribing the wrong fiscal policies but also the tight monetary policy aimed designed to raising interest rate and attract short-term capital flows were misplaced as high interest rates made debt servicing by the borrowing nation problematic, whilst safeguarding the interests of foreign creditors. Again because the IMF has repeatedly acted as a lackey of foreign lenders rather than developing country borrowers, anti-globalisers have called for a complete change in the IMF policy mindset or its abolition.
3. The bailout packages designed by the IMF basically transferred the risks incurred by foreign creditors as a result of their moral hazard lending to the borrowing nation. The bailouts were eventually financed by the taxpayers by the poor countries and again showed that the IMF policies were inimical to the interests of developing countries as they were pro-foreign creditors and anti-poor.
4. Anti-globalisers argued that bankruptcies that followed in the wake of a financial crisis were due systemic failures and not mismanagement. International bankruptcy laws should therefore be reformed to make foreign creditors share in the restructuring of bankrupt firms by buying equity in them.
5. Anti-globalisers also contended that giving functions of functions of automatic bailouts would only encourage moral hazard behaviour by the foreign creditors. During the Asian Crisis the IMF bailouts were too little too late and the IMF had shown that it was incapable of acting as an effective lender of last resort and play a useful role in crisis prevention. This provided yet another argument for the radical change in the policy mindset of the IMF and some critics called for its abolition (Niskanen 1999).

The reform of the international financial architecture has led to calls for revamping the global reserve system by issuing a new form of fiat money called “global greenbacks” similar Keynes’s *bancor*. The global greenbacks could be used to finance global public goods and

demonstrate that the international financial architecture could be used to stabilise the global economy whilst delivering equity and social justice (Stiglitz 2006:266).

IX. Macroeconomic policy challenges

In configuring the correct macroeconomic policy-mix for a globalising economy like Sri Lanka policymakers need to recognise the challenges posed by the existence of the 'open economy trilemma' or the 'impossible trinity' (Obstfeld 1998). This trilemma arises because policymakers at given juncture, can simultaneously choose only two out of the following three policy regimes:

1. Exchange rate stability.
2. Capital mobility.
3. Independent monetary policy.

Until recently policymakers in Sri Lanka chose options 1 and 3, i.e. the pegged exchange rate and independent monetary policy to address short-term macroeconomic stabilisation goals. However, the floating of the exchange rate (i.e. allowing market forces to determine the exchange rate or price of foreign currency instead of it being set by the Central Bank) opens up a new policy ball game.

Floating the exchange rate gives policymakers in an open economy like Sri Lanka more scope to liberalise the capital account and tap into the global pool of saving by encouraging long-term rather than short-term capital inflows. Capital controls are difficult to administer and often evade regulation either through innovative ploys or through bribery and corruption.

The 'original sin' or incurring foreign debt in hard currency can increase the burden of foreign debt when measured in domestic currency if exchange rate suddenly depreciates (Eichengreen and Hausman 1999). The original sin and exchange rate volatility instils the 'fear of floating' in developing countries (Calvo and Reinhart 2002). However, Sri Lanka has decided to bite the bullet and has now opted to choose the float in the bipolar solution set available to a globalised economy (Fischer 2001).

The free float of the rupee has opened up new policy challenges and opportunities. I shall briefly touch on two of them. First, there is the opportunity to design policies to harness the benefits of the correct brand of capital flows and bridge the widening saving investment gap and galvanise long-term growth as foreshadowed by the Solow growth model. Second, a new policy challenge has emerged with the removal of the exchange rate anchor that imposed monetary policy discipline and policy credibility under the pegged exchange rate regime. Under the new floating exchange rate with capital mobility there is scope to implement the policy package of 'Inflation targeting with Central Bank Independence (CBI)' as suggested elsewhere (Karunaratne 2006b). The implementation of this new policy package will rein in Sri Lanka's galloping inflation by honing down inflationary expectations. Inflationary expectations are undoubtedly feeding Sri Lanka's high inflation rate because the current monetary policy configuration allows for discretionary policy and time-inconsistent behaviour driven by the political business cycle. Some conservative policymakers may consider the new policy approach as radical and not geared to the needs for developing economy like Sri Lanka. It should noted that many born again Asian miracle economies have joined the inflation targeters league. These Asian developing economies have demonstrated that inflation targeting using Taylor rate rules yield rich dividends in the form low inflation with high growth.

X. Concluding comments

The forces of globalisation have the potential to offer developing countries a cornucopia. The implementation of a proper macroeconomic policy-mix is important to achieve short-term stabilisation goals that underpin the achievement of long-term growth without experiencing the trauma of a financial crisis. However, it should be borne in mind that the bottom line in evaluating whether economic policies have harnessed the benefits of the dynamic forces of globalisation needs to be judged on the basis of delivery in relation to growth with equity. In the past globalisation has been mismanaged and it has failed to deliver on growth with equity. But "We can make globalisation, work not just for the rich and powerful but for all people,……….We have already waited far too long. The time to begin is now." (Stiglitz 2006:292).

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