Trade and Finance in Development Thinking

José Antonio Ocampo

Abstract

This chapter summarizes the controversies on trade and finance in relation to developing countries as they have evolved since the Second World War. It shows the significant divergences among schools of development thought as to the role of the global system versus national policies in determining development success, and between those who defend the virtues of markets versus those who consider that development is intrinsically tied to some forms of state intervention. It follows a historical sequence, from what it terms the "industrialization consensus" of the early post-war years through the rise of newly-industrialized countries (NICs) as exporters of manufactures, to the "Washington consensus" and the most recent challenges associated to the rise of China and the recent slowdown of international trade. Through this

analysis, it also takes a look at changes in the global economic order and initiatives aimed at redesigning the rules for the global economy.

Keywords: trade, finance, liberalization, global economic order, globalization, international division of labor, newly-industrialized countries (NICs).

Introduction

Trade and finance have always figured out at the center of development debates. However, there have been significant divergences among schools of development thought as to the role of the global system vs. national policies in determining development success, and between those who defend the virtues of markets versus those who consider that development is intrinsically tied to some forms of state intervention. This chapter summarizes these controversies as they have evolved since World War II. It follows a historical sequence and takes a look not only at the development debates as such but also at the evolving global economic order in which they took place and initiatives aimed at redesigning the rules for the global economy. It uses as a point of reference the concept of two globalization processes: a first that covers the last decades of the nineteenth century and the first of the twentieth century,[1] which had collapsed when our story starts, and a second that began in the 1960s and 1970s and continues until the present.

The chapter is divided in three parts. The first looks at the early post-war decades, during which the global economy started to be reconstituted after the collapse of the "first globalization" and in terms of development there was a rise of what I will call the "industrialization consensus". The second considers the succeeding phase, which was characterized by the rise of the newly-

industrialized countries (NICs) as exporters of manufactures and the reconstruction of a dynamic but volatile international financial system that would end up in the first boom-bust cycle that would engulf part of the developing world. This period also encompasses the two oil shocks of the 1970s and the heated controversies around a New International Economic Order (NIEO). The third part focuses on the consolidation of a "second globalization" and the spread of market liberalization. In this regard, I will use the term "Washington consensus", though recognizing that it refers to the broad agenda of market reforms rather than the initial Decalogue proposed by Williamson (1990).

The old division of labor and the "industrialization consensus"

The point of departure of our analysis is the collapse of the "first globalization". This process started during the World War I, which damaged in a permanent way the gold standard and left permanent scars on Western Europe and, particular, on the country that was at center of that globalization, Great Britain. The death sentence came, however, with the Great Depression, which had strong effects on the alternative emerging global center, the United States, and would bring with it the collapse of the global financial system and the multilateral trading order.

An element of continuity between the old order and the one that emerged after the Second World War was an international trading system in which the developing world was essentially specialized in primary goods destined to the industrial center, with the terms of trade between commodities and manufactures constituting the essential relative price linking the two parts of the system. In any case, as a result of the collapse of the world trading system during the 1930s (and in part since WWI), many developing countries turned inward, in a sense forced by the circumstances rather than by true policy choice. However, as these inward-looking processes unfolded their benefits and provided an alternative engine of growth, industrialization became an increasingly conscious development strategy. Such strategy had some features in common with the phenomenon of late industrialization analyzed by Gerschenkron (1962), in particular the increasing levels of state intervention. Latin America and Central and Eastern Europe were the most successful cases of these "late-late" industrialization drives, as well as of the new ideas on the relation between industrialization and development.

The early post-war debates were dominated by an academic and policy debate on the disadvantages for developing countries of the existing international division of labor. They led to what can be called the "industrialization consensus": industrialization was seen as the road to

economic development, in the triple sense of being the mechanism of transmitting technological progress, generating external economies that accelerated economic growth, and absorbing the rural but increasingly also urban surplus labor (underemployment). As there were few export opportunities aside from commodity exports, that meant continuing looking inwards and erecting protection barriers.

The major issues raised were, therefore, how to manage the external economies associated with industrial development, building the modern infrastructure that was necessary to further it, and financing the investments associated with industrialization, infrastructure and the related urbanization process. This was the background for one of the most interesting controversies of classical development economics. One side, best represented by Rosenstein-Rodan (1943), claimed that the external economies (backward and forward linkages, in Hirschman's terminology) and the system-wide scale economies that they generated required a "big (investment) push." The alternative view, best exposed by Hirschman (1958), claimed that such balanced growth was impossible, due to both its financing requirements and the limited capacity of the states that were called to undertake such a strategy. In this alternative view, successful development could only be solved in a sequential way and through a series of imbalances.

The basic advantage of industrialization was the capacity to adopt technology that had already been developed in the industrial world and to benefit from the "unlimited supplies of labor" that characterized developing countries, to use the terminology then advanced by Lewis (1954). These advantages were perhaps less evident than was recognized at the time. Successful technological catching up was actually a more active process than initially foreseen, as it required adaptation, learning and developing the capacity to innovate –areas that would be later emphasized by Lall (2001), among others. The unlimited supplies of labor could only be produced by the destruction of pre-capitalist rural structures, which generated social problems of their own. Industrialization and the associated infrastructure and urbanization process also had high investment requirements and some industrial projects had uncertain returns in protected domestic markets.

This was all made more difficult by the scarcity of international financing, which was largely limited to official flows. The World Bank was the only agent in the still incipient system of multilateral development financing, joined later by the regional development banks, with the Inter-American being the first in 1959. It was complemented by official development assistance

and trade financing, including in the latter case that provided by the export-import banks from industrial countries. At the domestic level, this meant expanding the role of the state, which took the main responsibility for infrastructure development, played a significant role in the creation of domestic financial institutions, and in several countries took a role as investor in "strategic" industrial sectors. Attracting foreign direct investment (FDI) in manufacturing was also part of the strategy, notably in Latin America, but it was frequently accompanied by rejection of old forms of FDI in natural resources and infrastructure.

The industrialization consensus was grounded in the empirical observation that development was associated with significant changes in economic structures in which industrial production took a leading role. Many economists contributed to corroborate this stylized fact, notably the first World Bank Chief Economist, Hollis Chenery (1979), Furthermore, Chenery et al. (1986) asserted that all (or at least most) successful manufacturing exporters had experienced a previous phase of import substitution. This was even more forcefully argued later on by Chang (2003), who claimed that this was also behind historical success stories even in the industrial world. However, this view was also subject to criticism, as it implied the violation of the classical

principles of comparative advantage, a criticism that was voiced by more orthodox economists, with Viner (1952) as an important example.

The industrialization consensus was also grounded in ideological visions—much as the Washington Consensus would later be. These ideologies were very attractive in a world in which markets had been discredited by the Great Depression and planning was seen as an instrument of successful economic performance, and in a world in which decolonization was taking root at the political level and industrialization was seen as a sign of greater economic autonomy and thus as a complement to political independence. But it was subject to ideological attacks from both right and left: the former for leading to the misallocation of resources, and the latter for generating new forms of external dependence. This led to the strange alliance between orthodox economics and neo-Marxists that, according to Hirschman (1981), was behind the decline of classical development economics.

The special disadvantages associated with commodity dependence were emphasized by Prebisch (1950) and Singer (1950), and had two different dimensions. The first was the claim that the world economy was a hierarchical system—a "center-periphery" system. This implied that,

unless the asymmetries of such system were addressed, world inequalities would be maintained or even become more acute. An essential point was the low income-elasticity of demand for raw materials (particularly agricultural goods), which created limited opportunities for developing countries, unless they industrialized. Industrialization also offered, as indicated, better opportunities for technological change, and thus for income growth. It was mixed with the second, related issue that specialization in primary goods subjected developing countries to the sharp cyclical swings of commodity prices, and possibly to a long-term downward trend of these prices vis-à-vis those of manufactures.

Although the case for overcoming the deficiencies of the existing division of labor was based on all of these arguments, the major focus of criticism by orthodox economists was the so-called Prebish-Singer (terms of trade) hypothesis. Interestingly, its validity was revived in the 1980s by two World Bank economists, Grilli and Yang (1988), leading to a copious recent literature that actually confirmed that the terms of trade of non-oil commodities deteriorated through most of the twentieth century, though not necessarily as a secular trend, that the trend was uneven across commodity groups (stronger for tropical agriculture followed by non-tropical agriculture, less clear for metals and not valid for oil), and that this trend had been preceded by an improvement

in relative commodity prices in the nineteenth early twentieth centuries, and followed by as strong upswing in the early twenty-first century (see Ocampo and Parra 2010; Erten and Ocampo 2012).

On the policy front, the major push for industrialization came from both the United Nations and the World Bank, which at least until the 1970s was clearly in favor of industrialization, as reflected in the views of its first Chief Economist. It was also reflected in the early post-war negotiations of an international trading system that led to the 1948 Havana Charter that created the International Trade Organization (ITO) and gave significant room for industrialization policies as well as commodity price agreements (Toye and Toye 2004: ch. 1). U.S. Congress only approved one part of this treaty, the General Agreements on Tariffs and Trade (GATT), which had been agreed in 1947, but the industrialization consensus would underline the negotiations that took place in the 1960 and 1970s. In turn, the issue of commodity price volatility eventually led to a proliferation of agreements that tried to regulate the world supply and demand of individual commodities, usually involving cooperation between producers and consumers. This trend became particularly strong when commodity prices collapsed in the mid-1950s. In this regard, there were ample precedents since the early part of the twentieth century

(Rowe, 1965) as well as Keynes' view that the post-war economic order should include a commodity buffer stock.

Emerging export opportunities, the fight for a new international division of labor, and the recreation of global finance

The recreation of world trade in the early post-war decades largely took place among industrial economies—and, in particular, among Western European countries. Thus, it largely left aside the developing world. However, opportunities to export low-skilled manufactures from developing countries started to spring up in the 1960s. The most direct effect of these new opportunities was the spread of export promotion policies, which took strong roots in the first generation of Asian tigers but also in other parts of the developing world. This was accompanied by economic integration among developing countries following two entirely different models: explicit policy decisions to launch integration processes, the best example being Latin America, and a more market-oriented process which resulted from growing trade in parts and components among export-oriented economies. The latter became part of the so-called "flying geese" model of East Asia, in which older export sectors were successively displaced from Japan to first and then

successively to a second and third generation of NICs, as the older generations of export-oriented economies moved up to export goods with a higher technological content.

From early on, it became clear that the more export-oriented economies tended to grow faster (see Chenery et al. 1986). As we will see below, the interpretation of this pattern would become a subject of significant debate, which centered about the reasons for the success of East Asia. A central policy issue in this regard was the possible role that protection had in hindering export development—its "anti-export bias" —rather than as potential complements. In fact, a few countries aside, export success was not associated during this period with the dismantling of protectionist policies. Rather, a new layer of interventionist trade policies aimed at promoting exports was added to a system of protection that was at best only gradually dismantled, thus generating "mixed" trade regimes which involved both import substitution and export promotion. Indeed, in several cases, the domestic market helped the process of mastering and adapting technology, and also provided the base upon which firms gradually generated market information and built a reputation that allowed them to successfully break into established international production and marketing channels. This possible complementarity between

protection and export promotion was formalized by Krugman (1990: ch. 12) as the case of "import substitution as export promotion".

The gradual entry of developing countries into manufacturing exports may be seen as a modification of the center-periphery model, in which mature manufacturing activities from the center were gradually displaced to the periphery (or, perhaps better, peripheries), as part of a broader process of technological transfer. However, the basic structure of the international trading system continued to be "center-periphery" in character. The "product cycle" literature of the 1960s analyzed some of the features of this transfer (e.g., Vernon 1966). As developing countries were unevenly prepared to enter into the new stage of development—among other reasons, by diverse prior industrialization experiences— this process led to a growing divergence among developing countries.[2] A related literature showed that technology gaps generate income differentials among countries (e.g., Krugman 1990: ch. 9). As technological change continued to be concentrated in the industrial countries, this also reinforced existing international income disparities and the role of transnational enterprises from the industrial centers as major engines of technological transfer and export growth in the developing world. Indeed, one of the

characteristics that took shape during this period was the increasing reorientation of FDI toward export activities.

The gradual transformation of the center-periphery system of international trade did nothing to moderate the call for global trading rules aimed at changing the international division of labor. The United Nations Conference on Trade and Development (UNCTAD), created in 1964, and under the initial leadership of Prebisch, took a leading role in calling for a new world trading system. This was followed by the more radicalized negotiations for a New International Economic Order (NIEO) that were launched by the United Nations in 1974 but collapsed in Cancun, Mexico, in 1981. The most significant gain was the acceptance of the principle of "special and differential treatment" in trade relations, although its concrete manifestation, the Generalized System of Preferences, remained limited in its scope.[3]

Overall, however, the world trading system did not evolve in the direction of the UNCTAD agenda, which included the reduction of tariff escalation according to the degree of processing of raw materials and of high tariff (peaks) for labor-intensive manufactures in which developing countries had a growing comparative advantage, as well as international cooperation to regulate

commodity markets. GATT, which had mainly been a mechanism to liberalize trade among developed countries, did little to benefit developing countries, aside from accepting the principle of special and differential treatment and allowing these countries to make very limited commitments to reduce protection. Rather, agriculture was excluded from GATT in the mid-1950s, textiles became subject to a series of quantitative restrictions that evolved into the multi-fiber agreement, and successful new industrial powers (including Japan but also some successful NICs) were penalized by major developed countries (notably the U.S.) with a new protectionist tool ironically called "voluntary export restraints".

In the area of commodities, the spread of international agreements in the 1960s started by come under significant strains early on, and UNCTAD's call for a common commodity fund—which echoed Keynes' proposals during the war years— was essentially ignored. The major development in the commodity area was the increasing nationalization of oil by developing countries, the creation of the Organization of Petroleum Exporting Countries (OPEC) in 1960, the gradual expansion of its membership, and the flexing of its muscles during the two major oil shocks of 1973 and 1979. However, as an exporters' cartel, OPEC also represented the abandonment of global cooperation among exporting and importing countries to manage

commodity markets, and its capacity to control oil markets was significantly weakened in the 1980s and 1990s.

The expansion of world trade and the new opportunities created to diversify the exports of the more successful developing countries, coincided since the 1960s with the reconstruction of the global financial system around the so called "Eurodollar market". As it predecessor prior to the 1930s, this global financial system has even stronger "center-periphery" features—a concept that is indeed frequently used today by orthodox economists to refer to the global financial system. Some developing countries started to tap this market at an early stage but their full incorporation only took place since the mid-1970s and was associated with the recycling of petrodollars. As the market was born and remained unregulated, it soon led to a first boom-bust cycle, which had devastating effects in the 1980s on Latin America and some other parts of the developing world. This was, of course, a repetition of a long history of financial instability, which had been illustrated in the classic analyses of Kindleberger (see Kindleberger and Aliber 2005) and more recently by Reinhart and Rogoff (2009), among others. Interestingly, rather than drawing the lessons learned in the area of domestic finance during the Great Depression, which led to a

stronger regulation, the rise of global finance led to pressure to liberalize domestic finance, with results that would become evident in the frequency of financial crises in the subsequent decades.

The second globalization and the liberalization paradigm

Global trends

The events of the 1960s and 1970s were the prelude to the deepening of global economic integration and the "second globalization". In the area of trade, the main manifestation was the increase in elasticity of world trade to world GDP.[4] This reflected, in turn, other phenomena, notably the fragmentation of value chains, which provided new export opportunities to developing countries. FDI in export activities and subcontracting by major global firms, which had started in the previous period, now became widespread. FDI also started to penetrate the service markets of developing countries, to the extent that policies in these countries allowed. The rapid expansion and diversification of global trade was combined, in turn, with a boom in global finance, which left its legacy in a myriad of financial crises. Two of those crises affected large parts of the developing world: the Latin American debt crisis of the 1980s and the succession of Asian, Russian and Latin American crises of 1997-2003. Another one had strong

repercussion in the industrial world, the European monetary crisis of 1992, and one would affect the world as a whole (but mainly the developed world), the global financial crisis of 2007-08.

At the conceptual level, the major manifestation was the collapse of the industrialization consensus and the rise of the market reform agenda, which came to be identified under the rubric of the "Washington consensus". Trade and domestic and external financial liberalization were some of the key elements of the new agenda, as part of a broader rolling back of the State. At the international level, the collapse of the NIEO negotiations was followed by the shift in global development debates from the United Nations to the World Bank, whose conditionality –many times mixed with IMF conditionality— was essential to spread the new paradigm, although its application was quite diverse across the developing world.

In terms of international policy, the previous fights of developing countries to redefine the international division of labor and commodity markets were buried, and the major institutional innovations were the creation of the World Trade Organization (WTO) in 1995 and the proliferation of free trade agreements. The long Uruguay Round of trade negotiations that led to the WTO extended the disciplines of global trade rules to developing countries—particularly to

middle-income countries—and expanded the scope of trade agreements to include services and intellectual property rights. Agriculture was brought back into the discipline of WTO, but allowing for high levels of protection and subsidies by industrial countries. During the first WTO ministerial in Singapore in 1986, developed countries proposed to further expand the disciplines of the Organization to include trade facilitation, government procurement, investment rules and competition rules—which thus became branded as the "Singapore issues". With the exception of the first, they were eventually withdrawn from WTO negotiations during the now more than decade-long Doha Round of trade negotiations, but were included with vengeance in several Free Trade Agreements (FTAs). The result was doubly paradoxical: multilateral rules were strengthened by WTO as the multilateral trading system was fragmented by FTAs, and the negotiating power of developing countries was weakened by the fragmented character of negotiations of FTAs with major industrial countries (Economic Partnership Agreements in the case of European Union). A leading author has thus characterized FTAs as the "termites" of the world trading system (Bhagwati 2008).

In the area of finance, although the Basle Committee on Banking Supervision was created in 1974 to establish minimum standards of banking regulation and supervision, its scope remained

rather limited, as well as of similar organizations in other areas of finance. So, global finance remained essentially unregulated until the eruption of the global financial crisis of 2007–08 led the Group of 20 to create the Financial Stability Board. Although the frequency of national financial crises led to the belief that prudential regulation and supervision had to be strengthened, this also came with a significant lag, both in the developing and the developed world.

Trade liberalization

Behind the controversies surrounding trade liberalization laid two interlinked debates. The first related to a concept of "efficiency" as the key to economic policy. Orthodox economists understood it as static efficiency, which implied a significant change from the focus on accelerating the transformation of production structures that was behind the industrialization consensus and the heterodox interpretations of development success—and which may be termed "dynamic efficiency". The second debate was associated with state intervention. In this regard, the liberalization paradigm called for "neutral incentives", which essentially implied dismantling trade interventions. In contrast, the alternative view gave a central role to active industrial (or, more broadly, production sector) policies as well as well-developed national innovation systems. In terms of their implication for trade policies under the new concept, the two alternative

paradigms could be summarized as the "orthodox" versus "structuralist" export-oriented strategies.

The first achieved full centrality in the debates with the contributions from Krueger (1978) and Bhagwati (1978), based on a large-scale study by the U.S. National Bureau of Economic Research. This study highlighted the inefficiencies associated with trade intervention policies, their anti-export bias and therefore the role of trade liberalization as an instrument for enhancing efficiency and exploiting the opportunities provided by international trade. It also emphasized that interventionist trade policies encouraged rent seeking by domestic firms looking to be shielded from competition. These views were mainstreamed into the policies of the World Bank, where Krueger served as Chief Economist from 1982 to 1986.

Simultaneously, a booming cross-country econometric literature started to show that developing countries with higher trade openness tended to grow faster. It was never clear, however, what was the connection between the static efficiency achieved by trade liberalization and faster economic growth, which was a dynamic effect. Rodriguez and Rodrik (2001) provided a devastating critique of that literature, indicating that there was no clear association between trade

policies and growth. Similar conclusions were presented in my own contributions to this debate, which were part of an UNCTAD report (UNCTAD 1992).

World Bank policies led to heated debates, which highlighted their mixed success. Most of Latin America and Africa continued to perform poorly through the 1990s, and only picked up in the first decade of the twenty-first century, but partly as a result of booming commodity prices. In turn, Central and Eastern European countries collapsed in different degrees during their own (broader) liberalization processes of the 1990s, again followed by recovery in the 2000s. In many of these cases, trade liberalization led to de-industrialization in variable degrees. This is in open contrast to the successful Asian stories (some of them going back to the 1960s), where export-led growth reinforced the industrialization process.

Controversies surrounding East Asian success were heated. Japanese dissatisfaction with the World Bank interpretations of such success was behind its willingness to finance the study *The East Asian Miracle* (World Bank 1993). But this study hardly solved the controversy, as it argued that the active state interventions by East Asian countries actually resulted in more or less "neutral incentives", which the study interpreted as the reasons for their success. This is in sharp

contrast to the alternative views of Amsden (1989 and 2001) and Wade (2003), among others, who emphasized the interventionist character of East Asian policies and their focus on structural change and technological upgrading of exports.

A more nuanced World Bank view of the links between trade liberalization of development was provided in its own evaluation of the 1990s reform programs (World Bank 2005: ch. 5), in which it argued that trade was an element of all successful processes, but that trade by itself was no guarantee of success. For that it was necessary that trade policies be part of a broader development strategy, which should include an appropriate macroeconomic policy, guaranteeing in particular a competitive and stable real exchange rate, trade institutions that helped local producers meet international quality standards, and investments in human capital, physical infrastructure and institutional development. It also pointed out that in some successful experiences, such as those of China and Mauritius, export promotion clearly preceded import liberalization. *The Growth Report* of the Commission on Growth and Development (2008) provided an even more nuanced view as, aside from reiterating the role of investments in human capital and infrastructure, it underscored the need to use the exchange and interest rates with explicit development objectives, and thus to be very cautious of capital account liberalization.

Both studies underscored the crucial role that exchange rate policies play in the success of the trade strategies, an issue that permeates other controversies, as we will see below.

The structuralist interpretations of the success stories emphasized the capacity of a given strategy to facilitate the technological upgrading of exports and domestic production generally (see, for example, Akyüz 2003 and Ocampo et al. 2009). These interpretations were grounded in a more careful look of industrialization and manufacturing experiences in the developing world (see, for example, the contributions to Helleiner 1994 and 1995). Coming from new trade theory, Grossman and Helpman (1995), among others, had also pointed out that not all sectors had the same capacity to induce technological change. In this line of thought, Hausmann et al. (2007) argued that that the "quality" of exports –which could be understood as its technological content— was the factor that induced faster economic growth, not trade openness per se. So, active industrial (and, more generally, production sector) policies, focused on increasing the technological contents of production, may be a necessary ingredient in a successful export-led strategy (see Rodrik 2007, and contributions to Cimoli et al. 2009).

In the more nuanced mainstream contributions, there is also a positive view of "horizontal" production sector policies—those with no sectorial bias—particularly those aimed at promoting technological innovation. These policies are suboptimal according to the structuralist paradigm, as sectors have different capacity to induce technological change and growth. In turn, a major criticism from the orthodox camp is that selective (or "vertical") policies involve "picking winners", a rather risky strategy and one that creates opportunities for rent seeking. A compromise solution suggested by the "new (or, more appropriately, neo-classical) structural economics" of Justin Lin (2012) is that there are stages of comparative advantage associated with the resources economies accumulate as they develop (an idea that goes back to Balassa, 1989), and thus that the problem of what sectors to promote is solved by looking at countries that are immediately ahead in the development ladder.

It can also be argued that developing new activities does involve risks of failure, but that such strategy is the essence of success stories even of individual private sector firms. Furthermore, it is a learning process in which "winners" are *created* rather than chosen a priori. This is in fact an idea that can be drawn from the (now old) "new trade literature" pioneered by Krugman (1990), in which comparative advantages are essentially created. In any case, active production sector

strategies do have additional institutional requirements that must be built up, again through a learning process. Perhaps because of these special institutional requirements, some economists, such as Rodrik, visualize exchange rate undervaluation as a substitute for industrial policies, as it also generates a bias in favor of tradable sectors. However, it is an imperfect substitute, as it is not a selective strategy and, if practiced by large economies, generates global imbalances.

A final remark could be added in relation to the role of natural resources, which continue to be the major source of exports in many poor countries and have again become more important for several middle-income countries over the past decade of high commodity prices. In this regard, the work by Sachs and Warner (1995) is widely regarded as the best attempt to show the disadvantages in terms of inducing growth of excessive reliance on these exports. Again, however, the essential element of success with natural resource intensive export strategies is the capacity to increase the technological content of exports, to exploit the linkages between natural resources with other sectors, and to diversify away from them in the long term, all of which seem to be at the center of the success stories of some developed countries (Blomström and Kokko 2007).

Financial liberalization

Financial liberalization generated its own successes and failures. The prior regime came to be pejoratively labeled financial "repression" and was characterized by highly regulated domestic finance, particularly of interest rates and credit allocation, by the role played by state-owned banks in several countries, and by the management of the balance of payments through foreign exchange and capital controls. The financial liberalization that followed was more diverse across the developing world than trade liberalization, as several countries maintained commercial and development state-owned banks, and capital account regulations of different character.

Financial liberalization was successful in several countries in inducing an expansion of private credit as proportion of GDP and of stock market capitalization in several developing countries – and more the former than the latter. The development of long-term credit and financial inclusion remained, however, overriding concerns. To reduce the dependence on external funding, the development of domestic bond markets became an important area of policy work, particularly after the Asian crisis, but success was more commonly associated with the growth of government rather than corporate bond markets. New paradigms were also developed to expand access to finance through microcredit and other means.

The major failure of liberalization was the sequence of financial crises, generated by the dual effect of strongly procyclical capital flows to developing countries and weak domestic financial regulation. Financial crises indeed became a frequent phenomenon, in sharp contrast with the era of financial repression. This was associated with both domestic and external financial liberalization, and led on many occasions to "twin crisis" (simultaneous domestic financial and balance of payments crises). Analyzing the experience of the Southern Cone countries of Latin America, which were among the first liberalizers, Diaz-Alejandro (1985) said it all in the title of one of his best known papers: "Good-bye financial repression, hello financial crash". An early idea, drawn also from the Southern Cone experience, was that the liberalization process should be sequential, with trade liberalization preceding financial liberalization (Edwards, 1984), but this was generally ignored in the following decades. Despite some efforts to re-regulate finance—an area in which several developing countries led the way, generally after their own financial crises—the risks of financial liberalization became a recurrent theme (see, for example, the contributions to Ocampo and Stiglitz 2008). A landmark in this debate was, undoubtedly, the IMF paper by Prasad et al. (2003), which recognized the high risks of associated with financial liberalization, which in a sense swamped the potential benefits that such liberalization could have on growth.

The most important issue is the interaction between liberalized financial sectors and macroeconomic dynamics, which leads to boom-bust cycles. This phenomenon was central to the Keynesian revolution and was developed with particular brilliance by Minsky (1982). As already mentioned, confirmation of this pattern has been provided by Kindleberger and Aliber (2005) and Reinhart and Rogoff (2009), among others. The essence of the story is the tendency of private agents to alternate through the business cycle between "risk appetite" (or, rather, underestimation of risks) and "flight to quality" (risk aversion). In turn, opinions and expectations of different agents feed back into each other, generating an alternation of contagion of optimism and of pessimism. Asymmetries of information typical of financial markets tend to accentuate these trends.

Boom-bust cycles are stronger for those agents that are considered riskier by financial markets, who experience easier availability of finance during booms followed by credit rationing and/or high costs of financing during crises. This is the situation faced by small enterprises and lower-income households even in mature industrial markets. It is also the situation of emerging and developing countries during crises (including currently peripheral Europe). One way of

understanding this phenomenon is that financial integration by developing countries into global financial markets is a segmented integration (Frenkel 2008), such as integration into a market that is segmented by risk categories. As a result, emerging economies experience boom-bust cycles independently of macroeconomic fundamentals (Calvo and Talvi 2008). Indeed, countries that are considered "successful" are inevitably brought into the boom, but this can lead to the accumulation of vulnerabilities that may lead to them to crises (Ffrench-Davis 2001).

Volatility is reflected in the behavior of risk spreads as well as in the availability and maturity of financing. All of them have procyclical effects. Risks tend to be more pronounced in developing countries due the proliferation of maturity and currency mismatches in private sector balance sheets. All forms of financing tend to be procyclical, but this pattern is sharper for short-term financing, which thus tends to be particularly risky (Rodrik and Velasco 2000). A recent diagnosis by the IMF (2011: ch. 4) indicate that the volatility of capital flows has increased over time and is sharper for emerging than for advanced economies. Bank and other capital flows are more volatile, followed by portfolio debt flows, but FDI volatility has increased and is now similar than that for portfolio debt flows.

Intense short-term movement, such as those produced after the August 1998 Russian moratoria and the September 2008 collapse of Lehman Brothers, are particularly traumatic. However, in practice the most difficult phenomena to manage in macroeconomic terms are *medium-term* cycles. Developing countries have experienced three such cycles since the 1970s and are in the midst of a fourth one: a boom in the second half of the 1970s followed by collapse in the 1980s; the boom in 1990-97 (shortly interrupted by the December 1994 Mexican crisis) followed by the sequence of emerging market crisis that started in East Asia in mid-1997; a new boom between 2003 and mid-2008 followed by the global effects of the collapse of Lehman Brothers; and a new boom since mid-2009 (shortly interrupted by the different episodes surrounding the euro crisis).

Historical evidence seems to indicate that the strength of the policies adopted by advanced economies to stabilize financial markets is critical for the length of the downward phase of the cycle. So, the massive interventions after the collapse of Lehman brothers were critical for the return to more normal financial conditions in the developing world in a relatively short time period (about a year). The same is true of massive support to Mexico after its December 1994 crisis (a few months). In contrast, weak and delayed action after the August 1982 Mexican

moratoria and the first stages of the East Asian crisis in 1997 lead to protracted crises in emerging markets (eight and six years, respectively).

Another factor that has mitigated the strength and length of crises is the reduced *external* vulnerability of developing countries after the Asian crisis generated by the combination of massive self-insurance through foreign reserve accumulation and the development of domestic bond markets. Both led to a sharp reduction in risk spreads between 2004 and 2007. Although this may be understood as reduced market segmentation, the fact that its counterpart is massive self-insurance indicates that market segmentation is still a feature of global finance, but one that can be mitigated with prudential policies.

As indicated, the major problems generated by boom-bust cycles are associated with procyclical private sector spending and induced vulnerabilities in balance sheets. However, the major complication is that this may reduce the space for traditional countercyclical macroeconomic policies, as attempts to cool down the economy during booms with increased interest rates would lead to additional capital inflows that would counteract the effect of monetary policy on private demand and may increase currency mismatches in portfolios. Given this constraint, the key to

appropriate countercyclical management is the expanded availability of policy instruments to manage the domestic effects of external boom-bust cycles. This is particularly so when we understand that macroeconomic stability goes beyond price stability and includes *real* and *financial* stability –i.e., avoiding sharp business cycles and domestic financial crises. So, it requires the integrated use of three broad set of policies to smooth the business cycle: fiscal policies; monetary and exchange rate policies (which are highly interlinked in the developing world) and macroprudential policies[5] (Ocampo 2008; Ocampo et al. 2009: chs. 5-6).

In this regard, an issue that links trade and finance is the relation between capital account volatility and exchange rate management. Some degree of exchange rate flexibility may be essential for macroeconomic management. However, it may also lead to exchange rate volatility and misalignment, both of which have significant adverse effects on trade. There is also no clear evidence that market forces that would tend to correct such misalignment. Hence the search for intermediate options between the extremes of fixed and totally flexible exchange rates (Williamson 2000). Managed flexibility seems to have become the preferred option to manage this challenge in the emerging world, with capital account management as a complement in some cases.

Emerging issues

At the global level, two trends are now reshaping global trade and finance. The first is the rise of emerging powers, a result of success of some of them in navigating through the second globalization. The most significant trend in terms of both trade and international investment is the rise of China, which in terms of its global effects overshadows that of all the other emerging economies. The second is the global financial crisis, which first led to the collapse and later to reduced dynamism of world trade.

The net effect is that the most important opportunities are associated now with South-South trade, which largely means trading with China. Its major positive effect has been rising commodity prices (World Bank 2009; Erten and Ocampo 2012). Its major negative feature is that the emerging China-centered trading system is highly center-periphery in the very old sense of the term: other developing countries mainly export primary goods (some of these exports being supported by Chinese investments) and import an increasingly diverse set of manufactured goods from the emerging industrial powerhouse. This has remarkably brought back old debates on the

disadvantage of this emerging feature of South-South trade that some claim is reinforcing the de-industrialization process in other parts of the developing world (see, in relation to Latin America, Gallagher and Porzecanski 2010). In turn, as a result of the lack of dynamism of international trade, domestic markets have come back as an attractive opportunity, not least in China. This may give rise to protectionist trends. Although such trends have not been widespread so far, they may become an increasing threat if the recovery of the industrial world continues to drag and that of China weakens.

These emerging trends are bringing back old debates on the links between trade, finance, and development. They will continue to shape intellectual controversies in the years to come.

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[1] This concept does not ignore that there were global economic processes that precede the globalization of the late nineteenth century, but correctly differentiates the older processes from the two contemporary globalizations by the degree of integration of commodity and financial markets that was possible since the late nineteenth century given advances in transportation and communications.

[2] Using the historical data collected by Angus Maddison, it is possibly to estimate that the standard deviation of per capita GDP growth of developing countries increased from 1.9% in 1950–57 to 3.5% in 1973–80 and stabilized around that level since. In contrast, a similar statistic for developed countries actually fell in the early post-war period and stabilized around 1% since the mid-1950s.

[3] See a detailed analysis of the UNCTAD conferences and the North-South negotiations in Toye and Toye (2004, chs. 9 and 10).

[4] Using data from the United Nations Statistical Division, the elasticity of real world exports to world GDP (at market prices) increased from 1.4 in 1970–86 to 2.4 in 1986–2007.

[5] Capital management techniques, if we use the terminology of Epstein, Grabel, and Jomo (2003).