Economic Development and the International Financial System

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Introduction

At the beginning of the new century, let us say up until 2002, the insertion of the emerging market economies into the global financial system—that had been evolving since the mid-1970s—seemed to have become a burden on economic growth and a source of instability for these emerging countries. There was little room for optimism about the prospects of these countries. The following five main stylized facts supported this view.

First, financial and currency crises in emerging market economies were increasingly frequent and intense. Considering only the major crises since the early 1990s, the list encompasses the cases of Mexico and Argentina in 1995, the five East Asian economies in 1997–8, Russia and Brazil in 1998–9, and Argentina and Turkey in 2001. Even the most favorable observers of the financial globalization process, such as the managing directors of the International Monetary Fund (IMF) at that time, assumed the continuity of this trend and the emergence of new crises in emerging market economies to be an intrinsic characteristic of the global financial system (Camdessus, 2000; Köhler, 2002).

Second, there was striking evidence of the volatility of capital flows and the propensity for international contagion. These characteristics were first observed with the repercussions of the Mexican crisis in 1995 and gained wide recognition with the strong global financial impacts of the Asian and Russian crises.

Third, the extreme cases of highly indebted countries, like Argentina and Brazil, weighed heavily in the diagnosis. At the end of the 1990s, both economies were locked in financial traps (Frenkel, 2008), with high country risk premia, slow growth (e.g. Brazil) or recession (e.g. Argentina), and great external financial fragility. The Argentine crisis erupted in 2001 and was followed by the default on its external debt. Brazil had experienced a currency crisis in 1998–9 without
defaulting on its external debt; however, even though the Brazilian exchange rate policy became more flexible after that episode, economic policy and performance were still locked in a financial trap at the beginning of the current decade.

Fourth, most of the emerging market economies seemed to have entered the global financial system in a segmented way (Frenkel, 2008). This phenomenon was evident in the highly indebted countries. However, several emerging market economies that had managed their policies in order to avoid high debt and financial traps also experienced segmented integration. Even after participating in the financial globalization process for a long time (almost three decades in the case of the Latin American economies), the financial assets of these countries constituted a class of assets whose yields included a considerable country risk premium. The country risk premia had reached a minimum level in 1997, just before the devaluation in Thailand occurred. But since then, country risk premia have increased and were still high at the beginning of 2000. Hence, given that the sum of the risk-free international rate and the country risk premium sets the floor for domestic interest rates, financial integration seems to have doomed emerging market economies to systematically higher interest rates than those of developed countries, with negative consequences for growth and income distribution.

There is one last negative aspect of the situation at the beginning of the current decade that is worth mentioning: the reversal of the initiatives for international reform followed in the wake of the crises in the mid and late 1990s. At that time, some initiatives were taken in order to improve the “international financial architecture”, to reduce volatility and contagion, to prevent crises and to improve the international management of potential future crises. However, since 2001, the US administration and the newly appointed authorities at the IMF have held on to the belief that the very existence of multilateral support mechanisms creates incentives for over-indebtedness and increases the probability of crises. Around this time, the IMF began to work on the Sovereign Debt Restructuring Mechanism (Krueger, 2002), but this initiative, originally suggested by the new US administration, was abandoned shortly thereafter. Simultaneously, interest in the “international financial architecture” also became fainter. By the early 2000s, the stability of the international financial linkages of emerging markets became more reliant on the spontaneous behavior of the markets than ever before.

In sum, far from delivering on its promise of greater stability and growth—as touted by the promoters of financial liberalization and opening—the process of financial globalization in most emerging market economies seemed to have created a new source of volatility and a burden on growth. In order to deal with the resulting volatility, these countries had to implement their own preventive and defensive measures without the support (and in many cases even against the orientation) of multilateral financial institutions. As already mentioned, these circumstances did not leave much room for optimism.
At that time, one of the authors of this paper (Frenkel, 2002) attempted to synthesize the difficulties confronted by emerging market economies as follows:

A country that intends to implement capital market and capital account regulations to avoid an unsustainable financial integration path has to confront the IMF and the pressure of financial markets. It is a difficult task, but some countries have managed to do it. With regard to this issue, the target is well defined. We should put our efforts into promoting the appropriate changes in the rules and conditionality of the IMF and other multilateral institutions.

In contrast, without an important effort of international cooperation it seems difficult to find ways out of the highly indebted emerging market countries’ situation, and more generally, to establish an institutional context capable of neutralizing the segmented integration. The essence of the problem lies in that there is an inconsistency between the Nation States and an international financial system that lacks most of the institutions that have been developed over time at national systems to improve their stability and the way they work.

The above diagnosis was not wrong, given the evidence accumulated up to 2002, but the pessimism was not justified a posteriori. Actually, in the next few years the countries found unforeseen ways to avoid unsustainable financial paths and high debt financial traps without confronting the IMF. Interestingly, the segmentation of emerging market assets almost vanished in the following years without any improvement in the international institutional setting. Those unforeseen novel trends have been associated with a remarkable change in emerging market economies’ financial integration and in the global system; in particular, the fact that developing countries started to become less dependent on foreign saving and that many of them actually became net suppliers of savings. This change first became apparent in 2002, and was more marked from 2003 onwards.

This paper aims to describe and discuss the main characteristics of this new way in which emerging market economies participated in global financial markets, as well as its implications for their economic performance. The section following this introduction describes the recent economic performance of emerging market economies associated with changes in the way in which they participate in global financial markets. It also surveys empirical evidence on the relationship between foreign saving, foreign exchange reserve accumulation and economic growth. The third section discusses at a theoretical level the role of competitive real exchange rates (RER) in the performance of emerging market economies and then surveys empirical evidence regarding the relationship between RER and economic growth. The major theoretical explanations for the RER-growth link are evaluated in the light of evidence provided by a set of recent studies. The final section concludes by arguing that the agenda for global capital markets reform should aim to incorporate the lessons learned from the period 2002–8. The main message here is that a deep reform should push for an international agreement on real exchange rate levels.
and exchange rate regimes that help developing countries follow export-led growth trajectories.

The new trends in global financial markets

The changes in the global financial system with respect to the aforementioned trends are well represented by two facts. First, up until mid-September 2008 there were no new crises in emerging market economies, in spite of the emergence of various episodes of financial turmoil in the period 2002–8. Remarkably, the sub-prime crisis in the United States did not trigger a financial crisis in any emerging market economy up until the collapse that followed the Lehman Brothers bankruptcy. Second, country risk premia have followed a declining trend since late 2002, and by mid-2005 they fell below the minimum value registered in the pre-Asian crisis period. In mid-2007, country risk premia, measured by the Emerging Markets Bond Index elaborated by JP Morgan (EMBI+), reached their historical low, significantly lower than the minimum level of the pre-Asian crisis period and also significantly lower than the spread of US high-yield bonds. Country risk premia only started to rise in July 2007, once the concerns about the sub-prime crisis emerged. However, since that moment up until the Lehman Brothers bankruptcy in mid-September 2008, the EMBI+ remained at levels comparable to the low records of the pre-Asian crises period, showing a fairly robust relative performance of emerging markets’ financial assets. It was only after the Lehman Brothers collapse that country risk premia increased substantially, reaching a peak of 860 basis points (bp) in October 2008 and then remaining around a mean of 680 bp until early 2009.

It should also be mentioned that parallel to these two developments in the global financial system, there has been a substantial acceleration of developing countries’ growth rate. Between 2002 and 2008, developing countries’ GDP had been growing at an average annual rate of 6.7 per cent; a substantial acceleration compared to the average annual growth rate of 4.8 per cent during the period 1991–2001.

These changes have been associated with a shift in the exchange rate regimes of emerging market economies. Flexibility is the key characteristic shared by the exchange rate policies of most of these countries. Traditionally, flexibility has meant that the exchange rate is determined in the foreign exchange market and the monetary authority in these markets is not bound to intervene. But in the present context of developing countries, flexibility also means that the monetary authority reserves the right to intervene in the foreign exchange market.

One advantage of this regime is its preventive role, as it cannot be a victim of speculative attacks. The regime combines the advantages of a floating regime, with the degrees of freedom of the monetary authority, to react to changes in the domestic and international contexts, and to accordingly adjust the
exchange rate behavior and the monetary policy to the changing needs of economic policy. In practice, if not de jure, in the recent experience of most of the emerging market economies we find the above mentioned exchange rate regime, which is generally called “managed floating” (Williamson, 2000; Bofinger and Wollmerhäuser, 2003).

The movement toward greater exchange rate flexibility by many developing countries has certainly contributed to the development of the above mentioned facts. In our view, however, the main change in the process of financial globalization has been wrought by another factor; namely, the reversal of net capital flows now moving from developing to developed countries. Many of the emerging market economies, which had initially entered the system as recipients of capital inflows financing current account deficits, have in recent years started to generate current account surpluses—or to reduce significantly the previous deficits—and to persistently accumulate foreign exchange reserves.

In a set of twenty-nine emerging market economies, only four showed a current account surplus in 1997. In the same set, the number of countries with current account surpluses was fourteen in 2001, eighteen in 2004 and fourteen in 2006. In the same set of countries, the ratio between the aggregate amount of the surpluses and the absolute value of the aggregate amount of the deficits was 0.35 in 1997, 1.40 in 2001, 3.93 in 2004, and 4.64 in 2006. Excluding China, the ratio was 0.04 in 1997, 1.13 in 2001, 2.73 in 2004, and 2.15 in 2006.

There was a turnaround in the circumstances under which these countries entered the international financial system—they shifted from being absorbers of external savings to becoming exporters of savings and intermediaries of international capital flows—and this changed their position in the global financial system. It is our claim that this reduction of foreign saving dependence in the period 2002–8 helped developing countries reduce the chances of facing external crisis, lower their risk premia and enhance economic growth. Our claim requires an explanation of the channels through which this has occurred.

Current account surpluses and the availability of large amounts of foreign exchange reserves are indicators of external robustness, as they indicate a low probability that the country will face difficulties in meeting its external commitments. These indicators are used by international investors in their portfolio decisions. Research has also shown that they perform well at predicting the probability of balance of payment crises (Kaminsky et al., 1998). It is therefore not difficult to see why both the perceived risk and the risk premia followed downward trends in the cases where the current account showed a surplus.

The emergence of a number of surplus countries can have beneficial effects on countries whose current account deficits still persist, and can benefit the system as a whole. Having fewer numbers of deficit countries in a context where many emerging market economies show surpluses diminishes the risk of herd behavior and contagion, and thus reduce the perceived risk of the deficit countries. The
emerging market asset class is more heterogeneous, and many of these assets correspond to robust economies. This configuration benefits the risk perception of deficit countries and the risk perception of the whole asset class.

Let us illustrate with two Latin American cases how the new trends in the balance of payments helped developing countries find ways to overcome the hard constraints confronted at the beginning of the present decade. The strong improvement in Brazil’s current account was the key factor that allowed the country to climb out of the financial trap in which it had been caught since the beginning of the new century. This improvement reduced the external financial fragility and induced a reduction of the country risk premium. The consequent fall in the international interest rate confronted by the country decelerated the growth of its external and public debts, and improved its sustainability prospects. Therefore, the shift from current account deficit to surplus led to a virtuous circle instead of the vicious circle configured by the financial trap.

Argentina’s debt restructuring illustrates a case where a country benefits from the emergence of a group of economies with current account surpluses. The default on the external debt was declared in December 2001, before the improvement in international financial market conditions. In early 2003, the government launched an initiative that offered a 75 per cent haircut on the face value of the original debt. More than 76 per cent of the debt under default accepted the swap. The success of the restructuring was surprising, given both the dimension of the restructured debt and the level of the haircut; the highest recorded in the recent globalization era. It is clear that the novel international financial conditions contributed to this result. The debt swap took place while country risk premia in emerging markets were falling, thus making it a sufficiently attractive offer, which just a few months earlier had been considered “unacceptable.”

The emergence of current account surplus (or reduction in current account deficits) and the accumulation of foreign exchange reserves have affected developing countries’ performance not exclusively by reducing risk premia and the perceived risk of crises. A recent and increasing series of comparative international studies suggest that these variables are key factors explaining recent economic growth acceleration in developing countries. This empirical literature shows that current account and foreign exchange reserves are positively correlated with economic growth. For instance, the influential work by Prasad et al. (2007) has shown that there is a positive correlation between current account balances and economic growth among non-industrial countries for the period 1970–2004. Similar results have been obtained by Bosworth and Collins (1999) and the United Nations Conference on Trade and Development (UNCTAD, 2008). On the other hand, the positive correlation between foreign reserve accumulation and economic growth has been documented by Polterovich and Popov (2002) and Levy-Yeyati and Sturzenegger (2007), among others.
Even when the positive correlation between these variables seems to be a well documented empirical fact, the mechanisms through which both current account surpluses and foreign exchange reserves accumulation favor economic growth are not necessarily obvious. One possible channel is related to the discussion above. International capital markets suffer from many imperfections that make financing to developing countries volatile and subject to sudden stops. This feature can affect growth in at least two ways. Massive capital outflows may lead to external crises with negative long-lasting effects on the economic structure and thus undermine long-run growth (Stiglitz, 2000). Even if crises could be avoided, the inherent volatility of capital flows may affect investment decisions and growth. By reducing volatility and the probability of crises, current account surpluses (or lower deficits) and foreign reserve accumulation may contribute to economic growth. These seem plausible stories. In fact, the work by Prasad et al. (2007) suggests that one of the reasons why higher growth was observed in countries that relied less on external savings is that they did not suffer from external crises. However, their study also indicates that the association between growth and the current account does not follow exclusively from avoiding crises, provided that the correlation also holds for sub-periods in which no crises were observed. This result suggests that the effects of current account surplus and foreign exchange reserve accumulation on economic growth do not operate exclusively by reducing volatility and the chances of crises.

Foreign savings, real exchange rate and economic growth

In the previous section, we argued that developing countries have found a novel way to enter the international financial markets by becoming net suppliers of capital. The consequent improvement in their current account balance has led to an acceleration of their rate of foreign assets accumulation. There seems to be a wide consensus that the main motivation behind this strategy is countries’ willingness to maintain competitive real exchange rates, or at least to avoid overvaluations. The findings of the literature surveyed above corroborate that both current account surpluses and reserve accumulation are highly and positively associated to competitive (or undervalued) real exchange rates (see, for example, Prasad et al., 2007). One hypothesis that has recently gained an increasing number of advocates is that both current account surpluses and the accumulation of foreign exchange reserve impact on economic growth by making the RER competitive. The results of a new series of research on the RER-growth link provide substantive support of this view.

In an early work, Razin and Collins (1999) show that competitive (undervalued) real exchange rates appear to be associated with more rapid economic growth for a sample of 93 countries over the period 1975–92. Aguirre and
Calderon (2005) use dynamic panel data techniques for a data set of 60 countries between 1965 and 2003. They find that moderately undervalued real exchange rates enhance economic growth. A recent work by Rodrik (2008) uses a panel data of 184 countries for the period 1950–2004 and also finds that these two variables are positively correlated. The estimated coefficients are significant for the whole period and for different sub-periods, which indicates that the relation is independent of the period under consideration. Using a two-stage panel growth regression, Rodrik also finds that competitive real exchange rate is associated with growth in industrial economic activities, and that the expansion in this sector correlates positively and significantly with aggregate economic growth. The result suggests that the effects of the real exchange rate on growth operate (at least partially) through the expansion of industrial (tradable) activities. The result is also important because it is free from reverse causation problems; at a firm level the real exchange rate can be interpreted as exogenous, something that cannot be assumed in aggregate cross-country analyses. With a similar objective, Eichengreen (2007) finds that—in a sample of 28 industries for 40 emerging markets countries in the period 1985–2003—undervalued real exchange rates are positively correlated with growth of industrial employment. Other studies obtaining similar results between competitive (undervalued) RER and growth are Bhalla (2008), Gala (2007), Hausman et al. (2005), and Prasad et al. (2007).

The literature reviewed so far suggests that the novel way in which countries entered international capital markets, via the generation of current account surpluses and the accumulation of reserves, enhances economic growth not only by reducing volatility and the risk of external crises, but mainly through its effect on the level of the real exchange rate. This seems to be a widely shared view both among academics and policy-makers. What remains under dispute are the channels through which the real exchange rate affects economic growth.

At the macroeconomic level, the debate revolves around whether economic growth in developing countries is supply or demand constrained. Under the former view, the intellectual roots of which go back to the neoclassical growth model (Solow, 1956), growth acceleration requires an increase in the savings rate, which will then be transformed into higher investment rates and capital accumulation. Ideally, in an open economy it would not matter whether the sources of savings are domestic or foreign. Moreover, if neoclassical production functions are a good description of the real world, one would expect savings to flow from rich countries with high capital–labor ratios to poor countries with low capital–labor ratios. Evidence has systematically run counter to this prediction. A common explanation for this “paradox” (Lucas, 1990) points to the existence of multiple imperfections in both domestic and international capital markets. As already mentioned, it is usually admitted that because of imperfections in the international capital markets, flows of finance to developing
countries are volatile and prone to sudden stops. Similarly, it is argued that underdeveloped domestic financial markets typically do a poor job at intermediating foreign savings and channeling them into productive uses. If these premises are reasonable enough, advocates of the supply-constrained view plausibly expect that countries with higher domestic saving rates would grow faster. The relevant question then concerns the causal channel going from more competitive real exchange rates to higher domestic saving rates.

Levy-Yeyati and Sturzenegger (2007)—following the well-known result of the standard Kalekian-structuralist model—point to the redistributive effects of devaluation. The transition to a more competitive real exchange rate implies a transfer of income from workers to firms via a decline in real wages. In an economy with financially constrained firms, higher saving rates, capital accumulation, and growth would follow.

Inspired by the recent Chinese experience, Dooley et al. (2004a and 2004b) suggest another possible channel. An undervalued real exchange rate implies a subsidy to exports relative to imports, which generates an increase in domestic saving relative to absorption, and consequently a current account surplus. In order to maintain the internal balance, a rise in the domestic interest rate is needed. In a financially repressed economy, the government would be able to set the domestic interest rate to restrain absorption and increase the saving rate. The resulting current account surplus and reserve accumulation in turn serve as collateral required to support the flows of foreign direct investment that sustain rapid growth.

Irrespective of the validity of the theoretical arguments, the RER–saving link seems to find little empirical support. Montiel and Serven (2008) test the correlation between the two variables for a set of 94 countries over the period 1975–2005. Using the (log) GDP deflator from the Penn World Tables as a proxy for the RER, the unconditional correlation analysis shows that a higher saving rate is strongly associated with a more appreciated real exchange rate. When they control for the level of income per capita, the correlation coefficient changes signs; namely, higher savings correlate with undervalued RER. However, the coefficient is very small and statistically significant only for the ten-year frequency, and not for the thirty-year frequency. The authors conclude that “saving is unlikely to provide the mechanism through which the real exchange rate affects growth.”

Proponents of the demand-constrained view are inspired by the Keynesian vision in which effective demand is the main driver of economic growth in economies with unemployed and/or underemployed workers. In an open economy, a competitive real exchange rate would lead to an increase in the demand for exports and import substitutes, and the additional demand to additional domestic production and income. Higher production would in turn lead, through the accelerator principle, to higher investment and growth. Additionally, the acceleration in aggregate demand growth has a reinforcing feedback
effect on labor productivity growth, sometimes called the “Kaldor-Verdoorn law” (Frenkel and Taylor, 2007). Furthermore, it is not difficult to show within the Keynesian framework that a depreciation of the real exchange rate leads to higher saving and investment rates, together with an improvement in the current account. This result fits the stylized facts.

In a closed system the source of the aggregate demand pull is not as relevant as in an open one. This distinction is well known in many parts of the developing world where economic growth has been recurrently constrained by shortages of foreign currency. This is a key aspect of the export-led growth strategy: the demand-pull is obtained simultaneously with a relaxation of the external constraint. Proponents of the export-led growth view, with John Williamson (2003 and 2006) as a notable example, have been pointing out for a long time the importance of a competitive real exchange rate as a key element in a development strategy that seeks to overcome the foreign exchange constraint. Interestingly, Keynesian economists of the balance of payment (BoP) constraint school have largely undermined the possibility that a competitive RER could contribute to relax the external constraint. A key assumption for such a conclusion is that income elasticities of exports and imports are fixed in the long-run (Thirlwall, 1979). This assumption may be too stringent if one is willing to consider relatively long RER departures from “equilibrium”. Barbosa-Filho (2006) suggests that with the reasonable assumption that trade elasticities can be altered by changes in the real exchange rate, the BoP constraint is no longer immutable as suggested in the standard model.

Levy-Yeyati and Sturzenegger (2007) are skeptical about export growth and import substitution being the factors explaining the positive correlation between competitive real exchange rate and growth. Their view rests on the finding that exports are negatively (and imports positively) correlated with reserve accumulation.

A third line of argumentation emphasizes the existence of positive externalities associated with the production of traded goods. Many appealing stories are possible, but all share the notion that a temporary undervaluation of the real exchange rate may solve the standard private versus public benefit dilemma. With higher profitability, tradable firms would find incentives to invest. Capital accumulation and productivity growth arising from the positive externality would follow. If this process is long enough, the tradable sector would have acquired a productivity level that would turn it profitable at the original relative prices. This type of idea has a long tradition in development economics. For instance, the use of competitive RER to protect infant industry can be explained along these lines. The Dutch disease problem shares the same logic but it is applied to the opposite case: real appreciation and shrinking the tradable sector.

Rodrik (2008) is a notable example of this third line of argumentation. He shows that a competitive real exchange rate can function as a second best
solution to compensate for the institutional and market failures that keep tradable firms from exploiting positive externalities. In his explanation, however, it is not clear why these failures affect tradable activities more proportionally than non-tradable ones (Eichengreen, 2007).

It seems fair to conclude this section by stating that there is robust evidence suggesting that a key channel through which current account surplus and foreign exchange reserve accumulation foster economic growth is by maintaining real exchange rates at competitive levels. However, we still need more research to assess, with higher precision, the channels through which the competitive RER–growth link operates.

**Broadening the pending agenda of reforms**

Under the light of the evidence shown in the previous section, the period 2002–8—with numerous developing countries exhibiting current account surpluses, financial robustness and accelerating rates of growth—can be seen as an amplification of a historical pattern. In the recent phase, more developing countries have followed paths that showed both current account surpluses and higher rates of growth. In some cases, those outcomes resulted from policies explicitly oriented to foster growth through the management of competitive exchange rates that simultaneously contribute to generate higher rates of growth, current account surpluses and the accumulation of reserves. In other cases, those outcomes resulted mainly from international factors that were exogenous to the countries’ economic policies (i.e. low international interest rates, high expansion of the US economy, rising commodity prices). However, even in cases where the outcomes cannot be attributed to domestic policies, the authorities aimed to strengthen external robustness throughout the accumulation of reserves. Thus, the recent pattern followed by numerous developing countries seems to have been an a posteriori confirmation of the policy lessons implicit in the above mentioned studies.

Regardless of the particular impact on individual countries, an important feature of the configuration in the period 2002–8 was its positive effects on the workings of the global financial system vis-à-vis the emerging market economies as a whole. This configuration significantly alleviated the most negative aspects that financial globalization had shown until the early 2000s. However, its benefits for developing countries have not been recognized by the multilateral financial institutions. The official doctrine of the IMF does not seem to see the virtues of that configuration in terms of financial robustness and growth. For instance, the institution continues officially to promote macroeconomic policies based on free floating and inflation targeting. Free floating could lead to exchange rate appreciation and therefore threaten external balance robustness, and economic growth.
The current global financial and economic crisis has brought the discussion about the international financial architecture back. The depth and length of the crisis seem to have persuaded political leaders and their advisors about the potential dangers of unregulated financial markets and free capital mobility. The emerging debate at international forums has so far focused on the degree of regulation of global financial markets and potential reforms of multilateral financial institutions. These initiatives seem to share the spirit of the proposals of the late 1990s and early 2000s, which were developed as a result of the crises in emerging markets economies. Regarding developing countries, those proposals focused on one of the most prominent failures of global financial markets, namely, the instability that affected emerging market economies. The proposals called for building institutions capable of preventing, managing and compensating for the instability of the system. This agenda is still valid today, as was vividly illustrated by the contagion effects of the developed countries’ financial crisis on the emerging markets’ economies from late 2008. However, it should be broadened to take into account the lessons from the period 2002–8.

One important lesson underlines the key role of markets for developing countries’ exports. The experience of financial globalization tells us that capital inflows and external savings are by no means substitutes for growth-cum-exports. Therefore, together with institutional reforms aimed at stabilizing the workings of the global financial system, developing countries should also call for a deeper reform, intended to consolidate the positive features of the 2002–8 configuration. For instance, they should pursue an international agreement on real exchange rates and exchange rate regimes that would allow developing countries to follow paths of high rates of growth-cum-exports.9

One common objection to the proposal of targeting competitive RER, current account surplus and foreign exchange reserves accumulation is that it implies a fallacy of composition. Certainly, this kind of strategy cannot be followed by all countries at the same time. However, there is a priori no inconsistency in proposing it only for developing countries as a group. Furthermore, the prediction derived from standard neoclassical growth theory that rich countries would tend to provide savings to poor countries in their development process has been criticized on many grounds, but it has never been accused of inconsistency. Our proposal simply states the opposite direction of saving flows, by interpreting empirical evidence as suggesting that developed countries can best contribute to poor countries’ development by providing markets for their (infant) products, instead of providing saving. Many historical experiences show that developing or poor countries have benefited from having a competitive RER and exporting to developed countries. These include the recovery of Western Europe and the development of Japan after the Second World War and the East Asian miracle since the mid-1960s. A priori, there are no significant differences between those experiences and the more recent cases, of which China is the most popular one.
Although not inconsistent, the proposed strategy may not be entirely effective if product competition among developing countries is high. Razmi and Blecker (2008), for instance, found that most developing countries compete with other developing country exporters of low-technology products rather than with industrialized country producers. In such a context, an uncoordinated strategy where all developing countries try to maintain a competitive RER may end up in a fallacy of composition. A situation like this would certainly call for international coordination, in order to reach an agreement on real exchange rate levels among developing and developed countries and avoid fallacy of composition effects. But even without coordination, developing countries may still find useful to maintain a competitive RER to foster activities that face developed country competition.

It has also been argued that the 2002–8 configurations implied a “global imbalance”. By the mid-2000s, some analysts argued that those imbalances would require an adjustment, which could end up in a severe global crisis (i.e. a “balance of financial terror”). It would be a mistake to think, as some analysts still do, that the current global financial crisis is the predicted crisis. The so-called global imbalances were by no means responsible of the current situation; the crisis resulted instead from the massive underestimation of risks by financial institutions and the very poor regulation of financial markets by the governments of developed countries (Dooley et al., 2009).

The implementation of the deeper reform we are suggesting is not an easy task. Garnering support for this reform in the international arena would require reviving the spirit of Bretton Woods in a setting in which developing countries should have the voice and the weight they presently lack within the international financial institutions. But every journey begins with a first step. In this case, the first step should be the acknowledgment of the lessons from the history of financial globalization and of the beneficial effects that an agreement on exchange rates would have both on developing and developed countries.

Notes

1. A previous version of this paper was presented at The Initiative for Policy Dialogue Meeting of the Task Force on Financial Markets Regulation at the University of Manchester’s Brooks World Poverty Institute, July 1–2, 2008. The authors would like to acknowledge the collaboration of Eleonora Tubio.
2. Principal Research Associate at CEDES and Professor at the University of Buenos Aires.
3. Research Associate at CEDES and PhD candidate at the University of Massachusetts, Amherst.
4. In fact, the sequence of crises in Latin America had started much earlier. Many of these countries had been participating in the process of financial globalization since it came into existence during the second half of the seventies. All of the Latin American economies that were financially integrated at that time (i.e. Argentina, Bolivia, Brazil,
Economic Development and the International Financial System

Chile, Colombia, Mexico, Uruguay and Venezuela) suffered external and financial crises (the so-called Latin American external debt crisis) in 1981–2. The smallest economies (Bolivia, Chile and Colombia) started to recover a few years later, but for the biggest economies (Argentina, Brazil and Mexico) the recovery did not start until the early 1990s.

5. In the 1980s, there was also a trend of net capital flows moving from low income to high income countries. But this was a transitory consequence of the external sector adjustments of Latin American economies after their crises. In the course of renegotiations of Latin America’s defaulted external debts, which lasted from 1982–90, there was no voluntary lending from private sources and most of these countries went through current account adjustments in order to pay some proportion of the interest dues.

6. The data set comprises 24 out of 25 countries included in the Emerging Markets index elaborated by MSCI Barra (Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Thailand and Turkey) in addition to Bulgaria, Ecuador, Panama, Ukraine and Venezuela.


8. Dutch disease models with these characteristics have been used to illustrate deindustrialization processes, such as in the U.K. under Margaret Thatcher’s government (Krugman, 1987) and in Latin America during the 1990s (Ros and Skott, 1998).

9. Suggestions for the implementation of an international agreement on real exchange rates have recently been presented by John Williamson (2006).

Bibliography


Frenkel and Rapetti


Economic Development and the International Financial System


