POLICY RESPONSES TO GLOBALIZATION
Damned If You Do, Worse If You Don't

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Meeting the Employment Challenge: Argentina, Brazil, and Mexico in the Global Economy. By Janine Berg, Christoph Ernst, and Peter Auer. Boulder, CO: Lynne Rienner Publishers, 2006. Pp. 247. $55.00 cloth.

Living with Debt: How to Limit the Risks of Sovereign Finance; Economic and Social Progress in Latin America, 2007 Report. Coordinated by Eduardo Borensztein, Eduardo Levi Yeyati, and Ugo Panizza. Washington, DC: Inter-American Development Bank; Cambridge, MA: David Rockefeller Center for Latin American Studies, Harvard University, 2006. Pp. 326.

Regional Financial Cooperation. Edited by José Antonio Ocampo. Washington, DC: United Nations Economic Commission for Latin America and the Caribbean; Brookings Institution Press, 2006. Pp. 375.

Integración económica en América Latina: Hacia una nueva comunidad regional en el siglo XXI. By Germán A. de la Reza. Mexico City: Universidad Autónoma Metropolitana Azcapotzalco; Plaza y Valdés, 2006. Pp. 327.

Finance for Development: Latin America in Comparative Perspective. By Barbara Stallings, with Rogerio Studart. Washington, DC: Brookings Institution Press; United Nations Economic Commission for Latin America and the Caribbean, 2006. Pp. 316. $26.95 paper.

Emerging Capital Markets and Globalization: The Latin American Experience. By Augusto de la Torre and Sergio L. Schmukler. Stanford, CA: Stanford University Press; Washington, DC: World Bank, 2007. Pp. 209. $24.95 paper.

These books represent an enormous investigative effort by researchers associated mainly with the premier international governmental organizations (IGOs). *Living with Debt* is the annual Economic and Social Progress Report from the Inter-American Development Bank (IDB), copublished with Harvard's David Rockefeller Center; *Emerging Capital Markets* is a joint issue by Stanford University and the World Bank; *Regional Financial Cooperation* and *Finance for Development* are both copublished by the

Brookings Institution and the United Nations Economic Commission for Latin America and the Caribbean; and *Meeting the Employment Challenge* is by economists at the International Labour Organization in Geneva. My greatest surprise in reading them was the degree to which all six, including the volume on employment by Berg, Ernst, and Auer and De la Reza's study of trade and economic integration, place questions of finance, money, and exchange rates front and center in their analyses.

It may help to review three background issues that are crucial for an appreciation of these works: first, the unholy trinity/trilemma of modern macroeconomic management; second, the extent of contemporary financial globalization; and third, the benefits of national financial development and how globalization influences this. The unholy trinity refers to the Mundell-Fleming model developed in the 1960s, which demonstrates that a country can have only two of the following three policy options: an independent monetary policy (by which the central bank expands and contracts liquidity with the objective of stable growth and low inflation), a fixed exchange rate (enabling producers of tradables to minimize exchange rate risk), and capital account openness (or freedom for cross-border investment flows of all types).[1] If, for example, the exchange rate is fixed and the capital account open, then the central bank must target the exchange rate by maintaining a tight enough monetary policy (i.e., high enough interest rates) to attract financial deposits, even if the domestic economy is sluggish and arguably in need of a stimulus to growth. If, instead, the exchange rate floats and the capital account is open, then monetary policy may respond to domestic imperatives, although expansionary policy will cause the currency to depreciate commensurately, often provoking inflation as imports become more expensive.

The progressive internationalization of money and credit markets is a second background theme. During the Bretton Woods era, stretching from the end of World War II to the early 1970s, the trilemma was not a problem. Countries had mostly closed capital accounts, and the majority of cross-border financial flows reflected either payments for purchases of goods and services (trade) or long-term foreign direct investment (FDI). Financial globalization began with the Eurodollar markets in the 1960s, expanded slowly after the major industrial democracies floated their currencies in the mid-1970s, then accelerated rapidly from the mid-1980s onward. Although partial capital controls, especially on short-term speculative flows, remain possible and often desirable, the worldwide move to

1. See Benjamin J. Cohen, "The Triad and the Unholy Trinity: Lessons for the Pacific Region," in Richard A. Higgott, Richard Leaver, and John Ravenhill, eds., *Pacific Economic Relations in the 1990s: Conflict or Cooperation?*, 133–158 (Sydney: Allen and Unwin; Boulder, CO: Lynne Rienner, 1993), and Maurice Obstfeld and Alan M. Taylor, *Global Capital Markets: Integration, Crisis, and Growth*, 29–41 (Cambridge: Cambridge University Press, 2004).

full financial integration via capital account liberalization (CAL) may be slowed or ameliorated but ultimately not resisted.

Three statistics illustrate financial globalization. First, the value of all financial assets in all countries owned by foreigners divided by the total world production of goods and services (gross foreign investment/gross domestic product [GDP]), a stock measure, was 5 percent in 1945, 25 percent in 1980, and 92 percent in 2000, far surpassing its previous high of just under 20 percent in the years prior to World War I.[2] Second, the pace of international capital flows has accelerated. Daily foreign exchange (FX) turnover in 1973 averaged $15 billion, and annual turnover was roughly equivalent to world GDP.[3] In 1992, annual FX turnover was twelve times GDP. By 2007, daily FX trading had reached $3.2 trillion, and annual FX turnover was twenty-three times world GDP. Third, stampedes out of a country's financial assets, causing abrupt and large currency devaluations, and often associated banking collapses and recessions (as in the peso, tequila, Asian, Russian, and Argentine crises), have become more frequent. In response, the world's central banks have topped up their war chests of official FX reserves. Sadly, these reserves constitute funds that then cannot be committed to long-term investment in their national economies, and this practice thus imparts a conservative bias to macroeconomic management worldwide. By 2000, the ratio of official reserves held by all major central banks to world GDP had risen to 5 percent, and by 2006, it was about 9 percent, representing an enormous amount of money defensively parked in gold and low-yield but highly liquid hard currency financial assets, especially U.S. Treasury securities. Even so, *daily* FX turnover in 2007 was three-quarters of the value of all official reserves held in all the world's major central banks, suggesting that any currency defense, particularly of a major currency, could easily prove inadequate. The key stylized fact thus far is that CAL may be resisted but will happen anyway, because there is strong pressure from the supply side of world financial markets and investors. I have alluded to the costs of CAL in terms of heightened volatility, crises, and a conservative bias to monetary and macroeconomic policy. Governments must manage as best they can.

Financial development or depth, the third background issue, is most easily defined as the ratio of a nation's domestic assets to its GDP. More sophisticated definitions give a higher score to a country with diverse financial institutions and instruments, providing long-term credit to the private business sector in the form of bank loans, bonds, and equity shares. There is a strong correlation between financial development and

2. Obstfeld and Taylor, *Global Capital Markets*, 52–53.

3. Unless otherwise noted, the author compiled all data from online databases of the World Bank, the Bank for International Settlements, and the United Nations Conference on Trade and Development, consulted in November 2007.

steady growth, and a growing contemporary consensus summarized by De la Torre and Schmukler (5–8) that the principal causal link runs from finance to growth, rather than vice versa.[4] If CAL and financial internationalization can be shown to promote either financial deepening or net additions to productive investment, then we may consider their costs at least partially mitigated.

Each of the books under review focuses on a different piece of the globalization puzzle outlined to this point. For ease of understanding, I have organized my discussion by issue: FDI, inward FDI in the financial sector, Latin American corporations accessing world capital markets, sovereign borrowing, and regional economic integration.

Meeting the Employment Challenge focuses on the creation of employment, the goal of democratic publics in Latin America and the Caribbean today, now that chronic high inflation and hyperinflation seem everywhere vanquished. This work provides a rich overview of labor market conditions and a recent policy history for Latin America's three largest economies, touching on the labor market implications of macroeconomic policies, trade, exports, privatization, the right to strike, and the possibilities for institutionalized social dialogue in the spirit of Western European social corporatism. The authors believe in active democratic management of capitalist markets. Although their analysis is wide ranging, I will focus more particularly on its financial aspects. They discuss FDI, often assumed to be the "best" sort of capital inflow because it is the least volatile. This is an important issue, as inward FDI stocks as a share of GDP in Latin America and the Caribbean were up from about 10 percent in 1990 to 37 percent in 2005. Berg and her coauthors note that the share in total FDI of mergers and acquisitions of existing firms, often but not always a result of privatization, has risen steadily, both in Latin America and in the rest of the developing world. Unfortunately, greenfield (new) FDI would be superior from the standpoint of creating net new productive capacity and jobs (116–118). Moreover, although vertical FDI (integration into a global production process) is less desirable in terms of both job creation and crowding-in of domestic investment, it is today more prevalent in Latin America than is horizontal FDI, where local backward and forward links exist or are created.

Interestingly, these criticisms of contemporary FDI on employment and equity grounds have recently been echoed by an unlikely source, the International Monetary Fund (IMF), whose official press summary of its biannual *World Economic Outlook* states in part: "Over the past two decades, income inequality has risen in most regions and countries. . . . Technological advances have contributed most to the recent rise in inequality. Increased

4. See also C. A. E. Goodhart, ed., *Financial Development and Economic Growth: Explaining the Links* (New York: Palgrave Macmillan, 2004).

financial globalization—and foreign direct investment in particular—has also played a role in increasing inequality, but . . . increased trade globalization is associated with a decline in inequality."[5] The problematic aspect of FDI, according to the IMF, results from the fact that it brings sophisticated technology, increases the relative demand for skilled as compared to unskilled labor, and thus worsens wage inequality.

Berg and colleagues also consider the current macroeconomic context problematic for employment and suggest financial and monetary policy shifts (204–206). They propose requiring the central bank to target employment, to explicitly pursue a non-overvalued exchange rate to maintain competitiveness of the tradables sector, and to maintain a low interest rate, the latter two policies being necessary, they claim, to maintain a level playing field between domestic and foreign firms. Unfortunately, in the presence of an open capital account, these desiderata may be unrealistic. The authors also offer interesting suggestions about tying debt repayment to macroeconomic conditions (a proposal echoed in the IDB report on public debt) and export receipts to a stabilization fund to be used for countercyclical employment generation.

Financial FDI, the entry of foreign banks into retail banking and the provision of financial services in Latin America, is a particular concern of Stallings and Studart. In accordance with currently prevailing wisdom, they hypothesize that state-owned banks will perform worst, domestic private banks (which should suffer from lack of vigorous competition in the absence of open trade in financial services) next best, and foreign banks best. Employing refreshingly uncomplicated yet innovative methods, they conclude that the reality is not that simple, for although the expected hierarchy holds true in East Asia, state banks perform rather better and foreign banks rather worse than expected in Latin America. The authors attribute this difference to the presence or absence of "good institutions," including the rule of law, low corruption, honest bureaucrats, and credible regulations, drawing on the World Bank's popular governance database.[6] Indeed, using detailed case studies of Chile, Brazil, and Mexico, and carefully comparing financial internationalization in Latin America to that in East Asia, they find that good institutions predict both banking performance and capital markets development (277, passim). International equity—the sum of international bank loans, international bonds, and foreign investment in the shares of local firms—exploded from 20 percent

5. IMF, *Press Points for Chapter 4: Globalization and Inequality, World Economic Outlook* (Washington, DC: IMF, 2007). Available at http://www.imf.org/external/pubs/ft/weo/2007/02/pdf/4sum.pdf.

6. For a similar endorsement of good institutions, see Ernesto Stein, Mariano Tommasi, Koldo Echebarría, Eduardo Lora, and Mark Payne, coordinators, *The Politics of Policies: Economic and Social Progress in Latin America, 2006 Report* (Washington, DC: Inter-American Development Bank, 2005).

to 50 percent of GDP in the major Latin American countries from 1995 to 2003, showing a more gradual (and digestible) rise in the major countries of East Asia, from 39 percent to 45 percent of GDP during the same period (126).[7] Among their key recommendations are (of course) macroeconomic stability and (less obviously) regulatory and policy continuity, which they consider a critical component of institutional development (277).

Capital markets globalization is the principal concern of World Bank economists De la Torre and Schmukler. They would have liked, it appears, to find that all good things—particularly financial globalization and domestic financial deepening in Latin America—go together, but they cannot ultimately support this conclusion. Drawing on a new World Bank financial database, they uncover several worrying trends. Small countries cannot support vibrant stock markets no matter how good their domestic institutions or firms, which puts them at a disadvantage in accessing long-term finance. Moreover, the very improvements in macroeconomic stability and national institutional quality that should improve the health and performance of Latin American banking systems and capital markets—and which are recommended by all of the volumes under review—are, perversely, also strongly correlated with decisions by the best national firms to seek capital abroad, often delisting from local stock exchanges in the process. The result is weakened capital markets, lowered national financial liquidity, and worse conditions of finance for small and medium-sized enterprises (SMEs), precisely those local firms that tend to employ more people and whose survival and prosperity would enhance equity (131–133, and passim). The aforementioned IMF 2007 report also highlights the adverse equity implications of financial internationalization for SMEs, as do Stallings and Studart (272–274).

Yet another component of financial internationalization is foreign debt, including public debt. The big problem with international sovereign debt is that, compared to the pre-debt crisis years of the late 1970s and very early 1980s, it is today larger instead of smaller as a share of GDP in most of Latin America and the Caribbean. Public and publicly guaranteed (PPG) debt was 12 percent of regional GDP in 1975, rising to 18 percent in 1980. But from 2000 to 2005, it averaged 22 percent of GDP. It is possible, to an extent, that the large foreign debts of Latin American and Caribbean governments today result not from policy makers' fecklessness, but rather from the systemic fact of financial globalization itself and the difficulties of resisting strong international incentives to borrow, even when that might not be prudent. The set of all of those in all world regions designated by the World Bank as middle-income countries reveals a pattern remarkably similar to that in Latin America. The ratio of PPG debt to GDP

7. These figures do not include FDI. If they did, the shares for Latin America would be approximately 35 percent and 86 percent in 1995 and 2003, respectively.

rose from 7 percent in 1975 to 13 percent in 1980, and registered a mean of 18 percent in 2000–2005.

Public debt is the subject of this year's IDB Economic and Social Progress Report 2007. Wisely, the team coordinated by Borensztein, Levi Yeyati, and Panizza never scolds, dedicating itself to the challenge of the volume's title: living with debt. The authors offer a compendium of suggestions for decreasing debt's riskiness by, for example, increasing the local currency component, lengthening the average maturity, and thinking carefully about the mix of lenders (private, official bilateral, official multilateral) and instruments (loans versus bonds, floated at home or abroad) employed. The data and arguments are clearly and comprehensively presented, with fascinating information on nineteenth-century Latin American bond markets and defaults, as well as country debt profiles, including some that gently question official statistics. One chapter applies the latest political economy models—of the fiscal choices of opportunistic policy makers and of distributive conflicts—to the design of borrowing instruments that could provide policy makers (and to a lesser extent investors) with personal incentives consistent with the public good of long-term macroeconomic stability. The innovative and highly readable report, while remaining within the bounds of IGO propriety, also pushes the limits.

The books written by De la Reza and edited by Ocampo are in some respects less technically sophisticated than those already profiled. Despite the involvement of the United Nations Economic Commission for Latin America and the Caribbean in promoting Ocampo's volume, the contributors are primarily individual scholars unable to call on the resources of major IGOs for beautiful graphs or deep founts of data. Most authors in both books are also explicitly engaged in advocacy, favoring closer regional economic integration after the model of the European Union and possibly also the Economic and Monetary Union (EMU). In addition, both volumes envision the international dimension of the conundrum of globalization not as a fixed constraint but instead as a parameter possibly subject to reform. They ask, Why not? and implicitly respond to the dilemma (trilemma! quadrilemma!) faced, as we have seen, by countries whose currencies must absorb exogenous shocks by flexibly adjusting their exchange rates to manage the interface with the rest of the world, while simultaneously serving as a store of value for local savers to enable the domestic financial deepening essential for growth. As De la Torre and Schmukler also note: "Unfortunately, the economic and geopolitical power to address the flaws in the international financial architecture resides with the industrial countries, which are also the countries with the least incentive to worry about it, except in those rare occasions when their financial centers are threatened by contagion" (155).

De la Reza and Ocampo remind us that a different way to conceptualize the challenge that globalization poses for developing countries is not simply as a technical problem of reforming national-level banking and capital markets regulations, or even of civil service reform and good governance, but also as an essentially political issue of the redesign of global financial architecture.[8] This, in turn, inevitably leads to consideration of the international balance of power. There are strong reasons to believe that the interstate political system is becoming more multipolar, reflecting, for example, the relative rise of China as a major power.[9] Latin America and the Caribbean might even come to miss the long financial and economic hegemony of the United States.

One response to the uncertainties of both financial globalization and a shifting global balance of political power is to move toward regional economic integration, not necessarily because the economic reasons to do so are watertight (of course they are not), but because it makes good political sense to be able to bargain collectively. Arguably the greatest failure of Latin American governments in the debt crisis of the 1980s was an utter inability to form a debtors' cartel—not to enforce default or countenance fiscal irresponsibility, but simply to have the interests of debtor countries represented collectively vis-à-vis the creditors' cartel of major multinational banks, international financial institutions, and creditor country governments.

It is to this dimension, as much political as economic, that the two studies of trade and financial integration speak. Today's prospects for intrahemispheric cooperation are better than they were in the 1960s through the 1980s, as most Latin American countries are now more or less stable democracies. Because their leaders are increasingly, if still imperfectly, accountable to voters, their international promises become more credible to potential partners.[10] Reza provides a wealth of useful legal and historical details about previous and current efforts at regional commercial and economic integration, and the volume edited by Ocampo chronicles episodes of financial and monetary cooperation worldwide. Neither book touches more than briefly on the interesting financial options of dollarization (as one solution to the "original sin" of national money being a non-reserve currency) or of overt monetary union, the option successfully chosen by the EMU thirteen. Yet both are quite clear that regional economic integra-

8. On the politics of global financial design, see Leslie Elliott Armijo, ed., *Debating the Global Financial Architecture* (Albany: State University of New York Press, 2002), and Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge, MA: Harvard University Press, 2007).

9. On rising multipolarity, see Leslie Elliott Armijo, "The BRICs Countries (Brazil, Russia, India, and China) as Analytical Concept: Insight or Mirage?" *Asian Perspective* 31, no. 4 (2007): 7–42, and Parag Khanna, "Waving Goodbye to Hegemony," *New York Times Magazine,* January 27, 2008, 34–41, 62–67.

10. On this point, the political scientist's democratic peace theory meets the economist's hypotheses about the necessity of international economic credibility.

tion, as one possible response to the challenge of financial globalization, is a quintessentially political process, necessarily involving competing interests, bargaining, and compromise. Neither book mentions Venezuela's very new initiative of the Bank of the South, recently endorsed with varying degrees of enthusiasm by the major South American governments, but we can expect to see more initiatives promoting regional cooperation, not all necessarily with a "Bolivarian" gloss.[11] Another more limited integration option with a possibly significant economic payoff would be the creation of a regional stock exchange, mentioned favorably by Stallings and Studart, though considered unrealistic by De la Torre and Schmukler.

The benefits of financial internationalization for developing countries were once thought to include lower volatility, as risks would be shared more widely, as well as a net increase in savings and thus productive investment. Financial globalization thus could support convergence in incomes per capita between slower-growing mature economies and faster-growing poor countries, as the latter would reap the benefits of adopting already-discovered technology. These outcomes have proved elusive. Today, even mainstream North American economists are deeply skeptical about the benefits of CAL for poor countries or those lacking already well-developed domestic financial institutions and regulations.[12] The problems of currency mismatch (dollar liabilities and local currency revenues) and exchange rate volatility can be ameliorated but not overcome by expert management in national finance ministries and central banks. The causal link between heightened cross-border capital flows and the public good of national financial development is a great deal more ambiguous than once hoped. Yet CAL (the flip side of financial globalization) will not, I think, be denied. The challenge is to manage it, both economically and politically. Perusing any of these books—ideally the full set—will provide food for thought.

11. See Sean W. Burges, "Building a Global Southern Coalition: The Competing Approaches of Brazil's Lula and Venezuela's Chávez," *Third World Quarterly*, 28 (2007): 1343–1358.

12. Obstfeld and Taylor, *Global Capital Markets*, 271–272.

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