Economic Reform in this Era of Globalization

16 country cases

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Preface

The G-20 economies range widely in incomes and institutional structures, and in the level of integration with the global economy. They account for almost 65 percent of the world's people, about 70 percent of the world's poor and more than 75 percent of the world economy.

At a meeting in Montreal in October 2000 the G-20 Finance Ministers and Central Bank Governors discussed globalization, its implications for growth, inequality, and economic security, and its challenges to public policy. The discussion revealed broad agreement—in the Montreal Consensus—on the main elements of a sound policy approach to meeting these challenges. At the same time Ministers recognized the need for further work to develop a deeper, shared understanding of globalization, its effects on economies and societies and the ways of maximizing its benefits. To this end, the members agreed to prepare case studies outlining their respective experience with economic integration.

At the fourth Ministerial meeting in New Delhi, India in November 2002, a decision was taken to publish this collection of case studies to help inform the ongoing global dialogue on how countries can reap the potential benefits of global economic and financial integration, and ensure that these benefits are widely and equitably distributed, while avoiding potential vulnerabilities to crises.

The overview summarizes some common themes from the Workshop held in Australia and the case studies prepared by Australia, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, Mexico, Russia, South Africa, Turkey, the United Kingdom, and the United States.

This publication does not attempt to project a common view on the issues at hand. Rather the case studies reflect the diversity of G-20 members' experiences with, and approaches to, increasingly global markets for goods, services, and capital.

I am confident that by outlining, from the perspective of policy makers themselves, the key challenges and opportunities they face in dealing with increasingly integrated markets, this publication will provide useful insights to further progress in ensuring a process of globalization that benefits all.

Jaswant Singh
Finance Minister
India

Overview

The steady liberalization of world markets for goods and services over the last half century has contributed to an enormous increase in global prosperity and welfare by increasing productivity and workers' incomes, promoting greater competition, and expanding consumers' access to higher quality products at lower prices. In the G-20 benefits have flowed to formerly very poor economies and to industrial economies.

Continuing the recent progress in reducing poverty and inequality in the G-20 and in the broader world requires improving recent policies and sustaining robust global growth. Closer international economic integration can prompt faster growth in living standards, but it is only one part of a comprehensive development policy. Governments have critical roles in creating a stable macroeconomic environment, and in investing in the institutions, education systems, health systems, and social safety nets essential for inclusive, stable, sustainable growth.

The case studies of G-20 members in this book are not a consolidated G-20 view of globalization. Instead, they reveal the diversity of experiences and policies. Some common themes emerge nonetheless.

Cross-border capital flows can boost average growth rates by allowing savings with otherwise low returns in rich countries to finance higher-productivity investments in poorer countries. But short-term capital flows can increase the variability of growth rates, unless carefully managed in the receiving countries. They can also increase the vulnerability to crises if there are unsustainable tensions among domestic economic policies, or if economic institutions and prudential supervision are inadequately developed. So, while openness to international financial flows brings important and long-lasting benefits, it can raise the cost of bad macroeconomic and structural policies, weak institutions, and political uncertainty.

Member experiences show that opening to international capital flows needs to be closely monitored. Careful sequencing is important to provide time to build domestic economic institutions and prudential supervision. The international community also has an important role—developing codes and standards based on shared experience, conducting surveillance and peer reviews, and providing technical assistance. A broader political challenge is for leaders to create a domestic climate supportive of policies that will build wealth. Such reforms can be enacted in balanced, timely policy packages that reduce the risk of crises.

As with economic adjustments arising from changes in factor and commodity prices, the changes from economic globalization can cause losses to some members of society. So effective social policies are an important element of a comprehensive public policy response to sustain a political consensus supporting open markets. Good social policies are also critical to meeting the economic challenges of globalization. Governments and the international community must work together to ensure the provision of efficient and affordable programs that help with transitional impacts of change—as well as those that provide the skills and knowledge for people and businesses to respond to the rapidly changing demands of the global market.

Countries that have embraced closer international economic integration and minimized or avoided economic crises have made large and sustained strides against poverty—on a scale unprecedented in human history. There is no evidence of a correlation between globalization and increasing national inequality. Instead, inequality has widened in some countries, narrowed in others, and changed little in the rest. The different outcomes seem to reflect different starting points, different national policies, and different national economic experiences. Although national inequality has widened in some countries, absolute living standards for the poor have not necessarily declined.

G-20 members' experiences

Market opening measures leading to greater flows of goods, capital, and knowledge have created greater prosperity and higher living standards for G-20 members, which have become more integrated with one another and the broader global economy over the past 20 years. Tariff rates have been cut, and cross-border capital flows have increased. As trade and investment have risen, international specialization has increased, productivity has grown, real economic output per capita has increased, and basic social indicators have improved (table 1). The impact on welfare from consumers' ability to purchase a wider range of goods and services at lower prices is more difficult to measure but also important.

Contrary to the belief of many critics, globalization has not led to widening income disparities. The numbers in extreme poverty in the G-20 have fallen dramatically over the last 20–30 years, and for the group as a whole, measures of inequality have declined modestly[1].

The diversity of country experiences in the G-20 case studies suggests that while market opening is desirable, it is not sufficient to maximize globalization's benefits. Fully benefiting from the forces of globalization requires well-developed domestic institutions, coherent and sustainable macroeconomic policies, and effective structural policies. Structural reforms are needed to ensure that economies can adjust flexibly to changing patterns of demand. Good health and education systems are needed to support productivity and provide the skills and abilities necessary for workers to produce the goods in demand on global and domestic markets. And effective social safety nets are needed to facilitate adjustment to changes in employment associated with developments in global markets—and to sustain a political consensus in favor of open markets.

The case studies of countries that have suffered financial crises in the last decade show that premature or poorly sequenced capital account liberalization can highlight inconsistencies in macroeconomic policies and increase the risk and magnitude of financial crises. Why? Because short-term capital inflows can be easily reversed. Better information flows and comparisons of country performances by participants in globalized financial markets have made policy coherence and sustainability more important—and raised the costs of delaying correction of unsustainable policies.

The case studies add to other evidence showing that economic integration has led to significant improvements in living standards. The benefits are broadly based, and there is no evidence that opening markets to trade and investment flows increase income inequality.

The G-20 experiences do not suggest that moving away from open markets would enhance economic performance, overall social welfare, or equity. They show that even members that suffered economic crises have not shied away from the opportunities provided by integration with global markets. Instead, they have set about building policies and institutions to maximize the benefits from economic globalization.

Some recurrent themes from the case studies

Trade liberalization

The experiences of G-20 members show that the process of integration into world markets for goods and services has contributed much to improved living standards. Access to foreign markets has allowed exporters to reap the benefits of returns to scale and scope, while imports have improved the quality and choice available to domestic consumers. The competitive discipline that comes from the actual or potential entry of foreign competitors has ensured that the benefits of more efficient production are passed on to consumers—in the former of lower prices and higher quality—rather than appropriated by participants in

TABLE 1

Economic globalization—selected G-20 indicators

	Average tariff rates (percent)[a]				Trade (percent of GDP)[b]			FDI inflows (percent of GDP)[c]			GDP per capita (PPP dollars)[d]					Life expectancy at birth (years)[e]			
	1980–84	1985–90	1991–95	1996–99	1960	1980	2000	1980	1990	1999	1960	1970	1980	1990	2000	1970	1980	1990	2000
Argentina	28.0	27.5	13.9	11.0	10.0	24.1	18.2	0.9	1.3	8.4	5,559	7,302	8,245	6,512	9,219	67	70	72	74
Australia	16.0	14.2	10.7	7.4	25.6	26.8	34.9	1.1	2.6	1.6	8,865	12,171	14,334	17,043	20,390	71	74	77	79
Brazil	47.6	45.8	21.0	15.7	18.8	20.2	20.1	0.8	0.2	6.2	2,235	3,057	5,199	4,924	5,459	59	63	66	68
Canada	12.0	9.1	8.7	6.1	—	50.7	78.0	2.2	1.3	4.0	8,947	12,307	16,167	18,933	20,559	72	75	77	79
China	49.5	38.8	39.9	16.7	0.0	18.7	43.9	—	1.0	3.9	673	783	1,067	1,858	3,117	62	67	69	70
France	11.0	8.7	8.0	9.6	20.8	36.8	51.0	0.5	1.1	2.7	7,543	11,668	15,103	18,093	19,558	72	74	77	79
Germany	11.0	8.7	8.0	9.6	—	40.7	56.1	0.0	0.1	2.5	7,685	10,849	14,113	15,932	17,799	70	73	75	77
India	74.3	99.4	61.9	27.8	9.6	12.7	19.6	0.0	0.1	0.5	753	868	938	1,309	1,746	49	54	59	63
Indonesia	33.0	27.9	20.1	13.2	—	42.0	62.4	0.2	1.0	–1.9	1,019	1,194	1,870	2,516	3,070	48	55	62	66
Italy	11.0	8.7	8.0	9.6	20.7	39.3	44.2	0.1	0.6	0.6	5,916	9,689	13,153	16,320	17,759	72	74	77	79
Japan	10.0	7.0	6.3	6.0	18.1	25.7	18.3	0.0	0.1	0.3	3,988	9,715	13,429	18,789	20,410	72	76	79	81
Korea	23.1	18.9	10.9	11.5	8.0	63.2	72.7	0.0	0.3	2.3	1,105	1,954	4,114	8,704	12,152	60	67	70	73
Mexico	24.7	16.7	12.8	16.9	14.9	15.7	62.4	1.0	1.0	2.5	3,155	4,320	6,289	6,097	6,655	62	67	71	73
Russia	—	—	9.4	11.7	—	—	54.5	—	0.0	1.7	—	—	8,203	7,762	4,523	—	67	69	65
Saudi Arabia	2.2	8.0	12.3	12.7	0.0	84.5	55.0	–2.0	1.8	–0.6	3,719	7,624	13,284	9,101	8,225	52	61	69	73
South Africa	29.0	17.4	10.2	8.2	—	—	39.7	—	—	1.1	3,041	4,045	4,390	3,966	3,858	53	57	62	48
Turkey	31.0	26.4	26.7	12.3	—	15.4	41.2	0.0	0.5	0.4	2,518	3,450	4,073	5,441	6,552	57	61	66	70
United Kingdom	11.0	8.7	8.0	9.6	31.7	42.1	43.7	1.9	3.3	5.9	8,645	10,767	12,928	16,411	18,714	72	74	76	77
United States	8.0	6.5	6.3	9.0	7.1	17.2	20.3	0.6	0.8	3.0	11,328	15,030	18,577	23,214	27,331	71	74	75	77
G-20 average	24.0	22.1	15.9	11.8	14.3	33.3	44.0	0.5	0.9	2.4	4,822	7,044	9,236	10,680	11,952	63	68	71	72

a. Source: World Bank.

b. Source: IMF.

c. Source: World Bank.

d. Source: Maddison (1990 US$).

e. Source: *World Development Indicators* database (World Bank).

Note: FDI inflows data, along with those on trade and tariffs, are taken from *Globalization and the G-20: Selected Indicators*, a tabulation distributed to G-20 deputies in October 2001.

protected industries. By spurring innovation, competitive discipline has been an important driver of efficiency and productivity growth in its own right.

The case studies illustrate that trade liberalization requires the effective management of the accompanying structural adjustment—and that public investments in education, training, and social safety nets are important to maximize its benefits and ensure they are available to all.

Capital account liberalization

The case studies reveal a range of experiences with opening economies and financial markets to foreign investment. Some members have had a highly open capital account regime throughout their modern economic history. Some have liberalized at different paces in recent decades. And some are slowly reducing controls on capital movements.

The diversity of starting positions—and the interaction of capital account arrangements with unique domestic economic structures, policies, and regulations—mean that it is not possible to formulate a guide to the pace and sequencing of liberalization for all countries to follow under all circumstances. Instead, the case studies provide instructive lessons that could help countries liberalizing their capital accounts. The most important of these lessons is that maximizing benefits from open capital markets requires sound economic policies within well-regulated, supervised, managed, and capitalized financial systems.

Members' experiences confirm that different forms of cross-border capital flows pose different issues for regulatory and prudential control—and for stability. Foreign direct investment flows tend to remain stable, to arise from a long-term commercial relationship, and to bring benefits in technology and management practices that can strengthen the recipient economy's economic performance. Short-term borrowings and portfolio investment flows, much more quickly reversed, are rarely the result of longer-term investor commitment to a country. Thus, they sometimes contribute to external crises, particularly in the context of inconsistencies in host-country macroeconomic policies, weaknesses in the domestic financial sector, and poor prudential supervision.

Structural policies

Closer global economic integration delivers its benefits by permitting greater specialization and by lifting domestic economic performance to global levels through intensified competition. The benefits imply structural change. The case studies show that benefiting fully from access to external markets requires an economy to smoothly allocate additional resources to the production of goods in strong demand and to withdraw resources from sectors where demand is declining.

The countries in the case studies have pursued a variety of structural policies to facilitate adjustment, reflecting the different starting points of their economies, the nature of their external liberalization efforts, and their domestic political preferences and social choices. In general, countries that have pursued policies fostering the responsiveness of firms, households, and workers to price signals have been most successful in meeting the challenges of globalization. This implies that structural reforms in seemingly domestic areas are, in fact, important to equipping the economy to respond to international opportunities.

Paradoxically, broader packages of economic change may involve fewer costs than narrower changes (because the losers from some changes may be gainers from others). Reforms in widely used sectors such as transport, power generation, and telecommunications have particular potential to improve overall economic performance by lowering costs and thus speeding the dividends from adaptation to global opportunities.

Transparency and sound financial sector regulation and supervision. Many of the case studies suggest that problems experienced after liberalizing the capital account were due mostly to inadequate transparency and insufficiently developed prudential and regulatory mechanisms. The international community has responded by developing standards and codes for economic and financial transparency and for policy in such key areas as financial sector regulation and supervision. It has also helped countries identify weaknesses in these areas through stronger surveillance, notably the Reports on Observance of Standards and Codes (ROSCs) by the IMF and the Financial Sector Assessment Program (FSAP) undertaken jointly by the IMF and World Bank. G-20 countries have played an active role in this process. At the first G-20 Ministerial meeting in Berlin in December 1999, the group endorsed the ROSC and FSAP exercises and agreed that member countries should participate in them.

Better information flows and comparisons of country performance by participants in globalized financial markets have made credibility and sustainability in government policy and regulation more important. Policy inconsistencies now tend to be more quickly identified and more severely punished by international markets. The case studies illustrate that building structural and institutional supports for a more global economy is a process best approached systematically, usually with international technical assistance or foreign financial expertise. Building domestic institutions and the effective machinery of prudential supervision is time-consuming—but essential.

Labor market reforms and competition policy. Strong labor market and competition frameworks are the structural policies most critical to ensuring smooth adaptation to the new, higher-productivity opportunities offered through open international markets. Labor markets are important in minimizing the extent and duration of unemployment. The case studies highlight that those countries with less-flexible labor markets encountered difficulties in allowing labor to move quickly to emerging sectors and reallocating other complementary resources, such as capital, from sectors experiencing a temporary or permanent decline in demand to expanding sectors.

The role of government. The experience of the G-20 members indicates that a thorough assessment of the appropriate role of government in the economy, including regulation and state ownership of firms, can help countries benefit fully from open international markets. There is no single "appropriate" level of government intervention for all countries. Instead, what is appropriate will vary depending on the historical, cultural, and institutional base of the country. But it is important for governments to actively consider, and periodically re-examine, the role their interventions ought to play in the economy—to ensure that the costs are justified by the need to achieve other public policy objectives. In addition, the process of assessment adds transparency and credibility to the reform agenda.

Social policies

A recurring theme in several case studies is how supportive social policies contribute to good economic performance. Opening markets adds to the pressures for far-reaching structural change. But the need for policies to help people and countries adapt to change also arises from other sources, such as technological advances or changes in relative prices that can also cause economic and social dislocation. Good social policies help in adapting to all changes, whatever their source.

The experiences of the countries studied show that effective social policies help sustain a political consensus that supports open markets. First, good policies ease the transition for those negatively affected by the permanent structural changes that can result from market-opening measures. Second, they provide social insurance against risks that are not privately insurable, such as the consequences of large shifts in demand. And third, they help people adjust to changing market conditions.

A well-developed education system and a health care system that provides portable coverage help contribute to an economy and labor market that is flexible and better able to adjust to shocks. Other types of social policies, such as labor retraining, matter for

BOX 1

The Benefits of World Trade Organization Membership

All G-20 members have chosen to be members of the World Trade Organization (WTO). G-20 governments have judged that membership in the WTO (and its predecessor, the GATT) has tended to improve access to external markets and has increased attractiveness as a destination for stable foreign direct investment. Membership also provides open, rules-based dispute resolution and a voice in the negotiation of global trade rules.

Most G-20 members have steadily reduced tariffs over the past 20 years, enjoying a corresponding increase in trade as a percentage of GDP from about 33 percent in 1980 to about 44 percent in 2000.

BOX 2

Capital account liberalization—lessons from G-20 experiences

Openness to cross-border capital flows is an important complement to open markets for goods and services, since integrated global capital markets allow poorer countries to finance investment beyond the limits permitted by domestic savings. Foreign direct investment (FDI)—a particularly stable and long-term form of international capital flow—also conveys the benefits of exposure to more advanced technologies and management than may be available domestically. OECD data show that developing countries, as a group, receive almost twice the inward FDI in proportion to their GDP as developed countries.

The case studies show how G-20 members have reduced barriers to cross-border capital flows over the past 20 years, enabling the consolidation of progress in economic and financial development, and set the stage for stronger growth and higher incomes. But they also show that without the necessary institutions and regulatory framework, particularly in the financial sector, volatile short-term capital flows can contribute to crises. Creating an environment to help countries obtain the benefits of an open capital account while minimizing vulnerability to crises has been an important impetus behind efforts by the international community to develop and promote standards and codes for economic and financial transparency—and policies for financial sector regulation and supervision.

Moreover, the Mexican crisis of 1995 highlighted that strictly implemented regulatory and institutional changes are required in addition to domestic reforms in institution building, property rights, and contract enforcement. To be successful the reform process must also remain flexible enough to address new domestic and global economic developments.

Korea's 1997 crisis reflected the culmination of structural imbalances, institutional shortcomings, and external shocks from the Thai and Indonesian crises. But the crisis proved a catalyst for domestic support for comprehensive economic reforms.

French and Chinese accounts of financial sector liberalization illustrate how measured approaches can develop domestic institutional and regulatory strengths, in step with opening to global capital markets.

The case studies show that members have refrained from reversing the broad direction of capital account liberalization in the face of crises. Instead, they have worked to build the institutions, prudential supervisory policies, and skills that reduce the risks of future crises. This determination to avoid reversing a policy of liberalizing the capital account can be viewed as the authorities' recognition of the long-run benefits of liberalization.

those directly affected by economic change. In the absence of effective social policies, the accelerated changes from integration in international markets can lead to opposition from those fearful of redundancy or of seeing traditional skills devalued. Even when the net benefits of liberalization for society are large, local areas of loss can be a powerful obstacle to change. Such opposition may undermine broader support for the reform process.

The degree to which policies should insulate people from adverse outcomes—rather than helping them to adjust—is of great practical policy importance. The case studies suggest that the best social policies will achieve their equity and social insurance objectives while contributing to flexible and efficient labor markets. The policies chosen will inevitably reflect a complex interplay of social preferences, political structure, historical, and institutional conditions. This is consistent with the observation in some case studies that labor market rigidities—although often resulting from well-intentioned, equity-oriented motives—can be counterproductive, exacting a high cost in economic efficiency and performance while failing to help the poor and marginalized.

Broadening the benefits of globalization—options for action

Both the case studies and the workshop on globalization, poverty, and inequality have identified useful policy lessons.

National policies

Globalization has not reduced national governments' capacity for vital interventions through domestic policy. No member government claims that it faces significantly reduced national capacity for action. The case studies also confirm that fully benefiting from globalization requires well-developed domestic institutions to support coherent and sustainable macroeconomic and structural policies.

The policies essential to maximize the benefits from globalization include:

- Liberalized trade and investment regimes.
- Cautious liberalization of the capital account, especially as it affects short-term capital flows.
- Institutional development, particularly in the legal and financial sectors, and careful regard to sound prudential regulation in the financial sector.

- Effective social programs and safety nets to facilitate the structural adjustments required to make the most of new opportunities.

The international financial institutions

A common theme in the case studies is the importance of international institutions in facilitating the reforms to fully capitalize on the potential benefit of globalization. In particular, these institutions can highlight other countries' best policy practices and identify desirable reforms.

Statistical improvements

Better comparability in national statistics would make the benefits of globalization clearer and improve analysis of the policies to maximize them. They would also promote broader understanding of trends in poverty and inequality. The Sydney workshop on Globalization, Poverty, and Inequality identified possible statistical action for countries:

- Participation or financial and technical support for the International Comparison Program (ICP). The ICP will produce more comprehensive, better quality, more timely, and better disseminated Purchasing Power Parity data. Such improvements would greatly facilitate public understanding of progress against poverty—and areas of remaining challenge.
- Better quality national household survey data on income or consumption, and better international comparability of such data, through supporting principles such as those enunciated by the Canberra Group and comparisons such as those facilitated by the Luxembourg Income Study.

Notes

1. For a range of estimates arriving at these conclusions by different methodologies, see David Dollar, "Global Economic Integration and Global Inequality", in *Globalisation, Living Standards and Inequality: Recent Progress and Continuing Challenges*, pp. 19–27; and Xavier Sala-I-Martin and Sanket Mohapatra, *Poverty, Inequality and the Distribution of Income in the G20*, background paper to the New Delhi G-20 Finance Ministers and Central Bank Governors' meeting, November 2002, available on the G-20 website.

Australia

Australia's experience with globalization falls in two waves, the first in the late 19th and early 20th centuries (bracketing Australian federation as a modern nation in 1901) and the second in the current era. Between these two waves Australia followed policies that had the (probably unintentional) effect of weakening Australia's links to the global economy, at a time when globalization was in retreat because of World Wars I and II and "beggar thy neighbor" responses to the Great Depression. This "de-globalization" reduced Australia's economic performance in both absolute terms and relative to other OECD economies, against which its performance is usually benchmarked. Conversely, in recent years policy reforms have reintegrated the Australian economy with the global one, leading to strong improvements in productivity and income growth.

Despite Australia's increased integration with the global economy, macroeconomic volatility has decreased. There has been strong growth in average incomes—yet, as in many OECD economies, the distribution of individuals' disposable incomes (after taxes and transfers) widened a little over the past two decades. But a targeted social safety net and a reformed tax system ensured that the household income distribution did not widen in the second half of the 1990s[1].

The reform process was not without frictions. And as with any national economic adjustment where the rest of the world's practices are also evolving, the process remains incomplete. Financial sector deregulation outpaced supervisory and corporate governance reforms for a period, and there were forced mergers of some minor banks and several large corporations. But those problems were corrected without reintroducing regulation.

Australia has enjoyed considerable benefits from its policy reforms supporting globalization. Moreover, the policy challenges of globalization have been met without adverse effects on aggregate employment and economic stability, and without contributing to poverty or inequality.

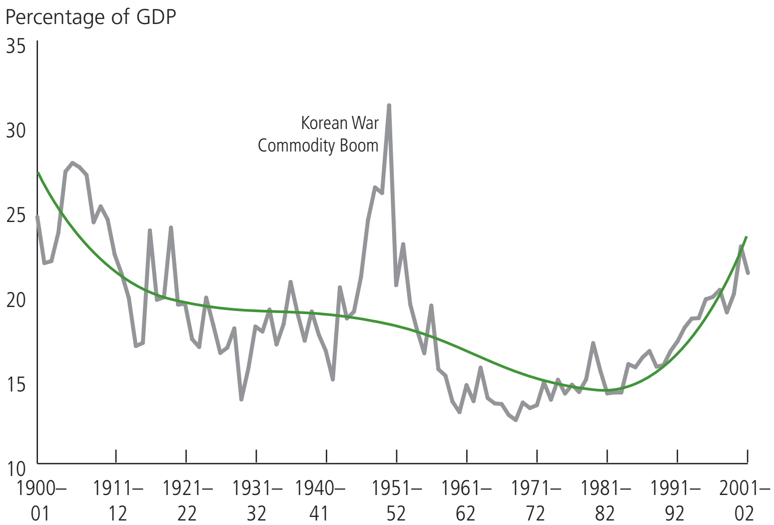
Two waves of globalization

Throughout the 19th century the Australian colonies flourished through primary industrial exports. As an exporter of raw materials to the British Empire, the modern Australian economy was effectively born globalized.

From white settlement in the late 1700s, a steady increase in population and economic activity took place, burgeoning in 1851 with the discovery of gold in Victoria. Immigration then accelerated, increasing the population from just over 400,000 people to around 1 million in a decade—and to about 3 million by 1890 (Catley 1996, p. 44). Between 1860 and 1870 real per capita gross domestic product (GDP) grew by about 5 percent a year. In 1870 the average per capita income of the Australian colonies was around 40 percent higher than in any other nation (Andersen and Garnaut 1987, pp. 15–17)—and 75 percent higher than in the United States (*The Economist*, 17 March 1984, p. 16).

But in 1888 the land and building boom collapsed, partly due to a slump in Britain, leading to a 25 percent cut in Australia's export prices and a drying up of capital inflows. Imports fell, government revenues shrank by a quarter, per capita income fell by around 10 percent, and unemployment rose sharply (Catley 1996, p. 45). The depression of the 1890s had a lasting influence on Australian policy throughout the early 20th century. Heavy

Figure 1. Australian exports, 1901–2002



Source: Australian Bureau of Statistics 2001a; Butlin 1962.

reliance on primary exports left the economy highly susceptible to fluctuations in world commodity prices, perhaps reinforcing the desire of Australian policymakers for employment and stability in the more diversified industrial economy they were trying to foster.

From federation in 1901 until the 1970s, Australia's economic development was shaped by inward-looking, protectionist policies that sought to build manufacturing industries behind a wall of tariffs. This approach was associated with a decline in Australia's high living standards relative to other nations. This domestic policy framework interacted with the two World Wars and the Great Depression to progressively disengage Australia from the world economy. Between 1900 and the mid-1980s growth in per capita GDP was weaker than in any other industrial country, causing Australia to fall from 1st to 14th place in terms of GDP per capita (Andersen and Garnaut 1987, pp. 15–17). Moreover, Australia's share of world exports fell from 1.7 percent in 1960 to 1.1 percent in 1987 (Kelly 1992, p. 14).

The oil price shocks and stagflation of the 1970s led, through regulated and inflexible labor markets, to persistently high unemployment in the 1980s. Australian governments recognized the untenability of the protectionist tradition, and significant and wide-ranging reforms were set in motion (see also below, in the section on labor market reforms). As Kelly (1992, p. 15) summarizes:

> The decade of the 1980s saw the advance towards a multi-racial Australia, the demise of protection, the start of the long-awaited assault on arbitration, a loss of confidence in State power and a turning away from government paternalism, a shift towards market power and deregulation to varying degrees, efforts to secure better enterprise productivity and work place reform, a deeper sense of national self-reliance, a reappraisal of welfare as a need not a right, and an emphasis on individual responsibility as well as individual entitlement. Australia's economic orientation was more outward-looking and its aspiration was to become an efficient and confident nation in the Asia Pacific.

Reforms to open markets

The transformation of the Australian economy was pervasive, and its benefits took time to emerge. But by the early 1990s the benefits of reintegrating with a globalizing economy were becoming clear.

Liberalization of controls on domestic markets for goods, services, capital, and access to foreign markets

Australia's market-opening reforms are perhaps most evident in the removal of trade and industrial protection measures and in the freeing up of capital markets and flows.

Removal of trade and industrial protection measures. The effective rate of protection in Australia rose steadily from the beginning of the 20th century until the 1970s—a significant factor in the fall in the ratio of trade to GDP (figure 1). The move away from protection began in 1973, commencing with a 25 percent cut in all tariffs in an effort to ease inflation and increase competitiveness and productivity.

The economic stress caused by oil price shocks, however, saw certain industries—such as passenger motor vehicles, textiles, clothing, and footwear—reprotected by quotas that persisted into the 1980s. But such protection was unable to sustain employment levels in the protected industries. Protection of textiles, clothing, and footwear, for example, more than doubled in the 1970s, yet employment levels fell (Higgins 1989). The share of manufacturing in GDP peaked in the early 1960s and declined through the 1990s as the service sector grew strongly.

After the lowering of tariff barriers in the 1970s and the adoption of a floating exchange rate in 1983, the ratio of exports and imports to GDP increased steadily. In the 1940s and early 1950s the share of exports in GDP (at current prices) was around 20 percent (see figure 1). It fell to about 15 percent in the late 1950s and stayed there until the 1980s. But by 2001–02 exports accounted for about 22 percent of GDP. This strong growth in exports was accompanied by a change in their composition—away from agriculture toward services and elaborately transformed manufacturing (figure 2).

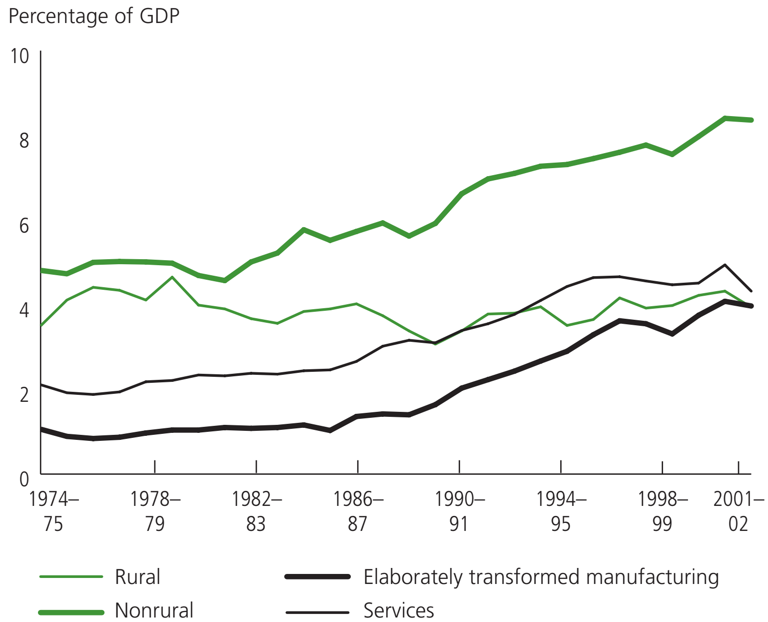
Destinations for Australian exports have also changed. During the 1930s nearly 60 percent of Australia's exports went to then-traditional trading partners in Europe—particularly France, Germany, and the United Kingdom. By 1996–97 such countries accounted for only 7 percent of Australia's exports of goods and services, while three-quarters went to partner economies in the Asia-Pacific Economic Cooperation group.

Freeing up of capital markets and flows. Through the late 1960s and early 1970s a national mining boom and associated rises in the stock market saw capital inflows to Australia accelerate sharply, with considerable inflationary effect. The government responded with measures aimed at reducing capital flows to contain inflation and ease pressure on the exchange rate.

By 1981 it was apparent that while perhaps effective in the short term, there was no reason for frequent or sustained use of capital controls. That year, a Committee of Inquiry into the Australian Financial System suggested that capital controls be available only during the transition to a more market-oriented foreign exchange system, and spurred Australia to embark on a relatively rapid transformation from one of the world's most regulated financial sectors to one of the more liberal (see below).

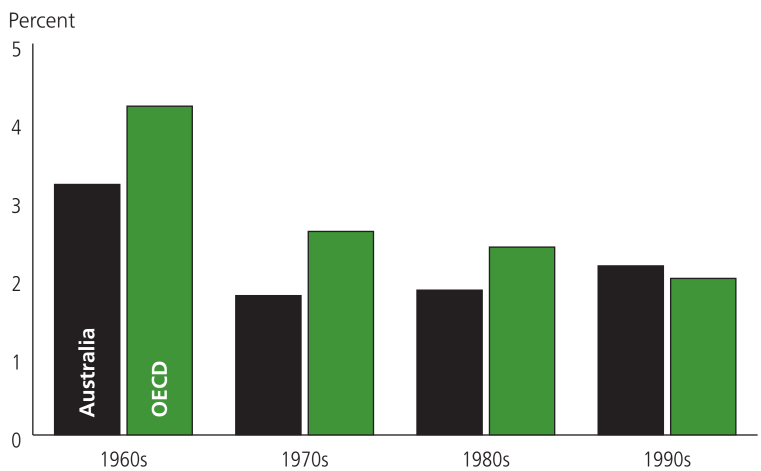
The phasing out of protectionist policies, together with financial deregulation and structural reforms in labor and product markets, led to an acceleration in economic growth rates. During the 1960s Australia's growth performance slipped below the OECD average. Below-average growth continued until the 1990s. But the 1990s (especially the second half) saw high productivity growth, strong growth in GDP and GDP per capita, low inflation, and falling unemployment—not only from Australia's perspective, but also relative to other major industrial countries (figure 3).

Figure 2. Sectoral composition of exports from Australia, 1974–2002



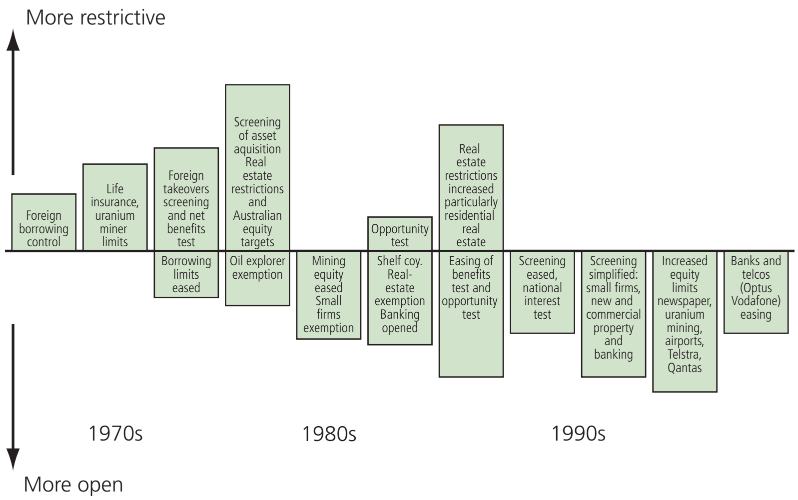
Source: Australian Bureau of Statistics 2002.

Figure 3. Average annual per capita GDP growth rates in Australia and other OECD countries, 1960s–1990s



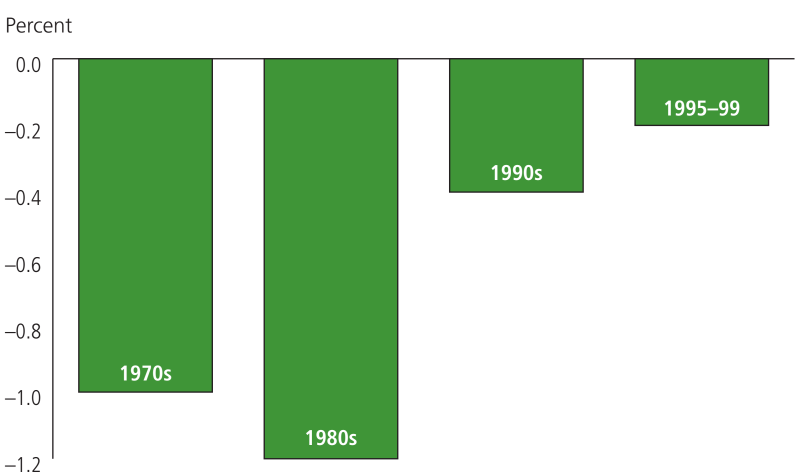
Source: Australian Bureau of Statistics Catalogue 2000a; OECD data.

Figure 4. Changes in foreign investment policy in Australia, 1970–99



Source: Evans 1999.

Figure 5. Changes in capital productivity in Australia, 1970–99



Source: Australian Bureau of Statistics 2000a.

Had Australia continued to underperform the average OECD growth rate for real per capita GDP over the past three decades by the same margin that it underperformed it in the 1960s, per capita GDP would now be almost 12 percent lower (A$3,500) than the actual level (Parkinson 2001).

Different treatment of different types of capital

Capital controls. Australia has long relied on capital inflows to supplement the domestic savings of its relatively small population. As a result sustained current account deficits were standard for most of the 19th and 20th centuries. In the years preceding the mining boom of the late 1960s, foreign capital predominantly consisted of direct investment—while in the early 1970s portfolio capital and institutional loans sometimes exceeded direct investment as sources of international capital. In the context of a fixed exchange rate (between the Australian and U.S. dollars), capital inflows were often inflationary and accompanied by speculation on the future of the exchange rate. But in the early 1970s the fixed exchange rate was abandoned, marking the first significant change in the exchange rate since 1949 and leading to a series of discrete shifts in the level of the peg.

As noted, during this period the Australian government implemented measures aimed at reducing capital inflows. The central feature was a variable deposit requirement, introduced in 1972, that acted as a market-based restriction on capital inflows. Under this scheme a portion of foreign loans had to be deposited in the Reserve Bank of Australia (in Australian dollars) in an interest-free, nonassignable account until loan repayments were made. By raising the cost of overseas borrowing, the variable deposit requirement effectively served as a tax on such funds. The requirement was suspended in 1977.

In 1981 the Committee of Inquiry into the Australian Financial System concluded that while the variable deposit requirement had been effective in the short term, there was no reason to reintroduce it or to make frequent or sustained use of it—or of other instruments like it (such as inflow or outflow taxes). Such controls on capital inflows imposed costs on borrowers and on overall economic activity by distorting resource allocations.

Foreign investment controls. Responding to rising nationalist sentiment, foreign investment policy became more restrictive between the late 1960s and mid-1980s (figure 4). This approach contributed to an increase in the share of the current account deficit financed by borrowings and portfolio debt inflows. It also may have reduced the efficiency of capital allocations (figure 5).

More recently, broader liberalization policies and the move away from protectionist policies have seen increased liberalization of the foreign investment regime, while maintaining the pre-establishment screening process. But since the mid-1980s the regulations guiding the vetting procedures have been eased considerably, resulting in a more open, efficient, investor-friendly regime[2].

Role of regional economic arrangements

Regional economic arrangements have not played a big role in the "reglobalization" of the Australian economy. That said, the Australia-New Zealand Closer Economic Relations Trade Agreement of 1983 and the APEC goal of increasing economic prosperity and improving social conditions (particularly through free and open trade and investment, as enunciated at the 1994 conference in Bogor, Indonesia) have contributed to the consolidation of domestic policies.

The benefits of the agreement with New Zealand are indicative of the benefits of regional economic arrangements. Its central provision is the creation of a free trade agreement consistent with World Trade Organization (WTO) requirements. All tariffs and quantitative restrictions on trade in goods between Australia and New Zealand have been eliminated. The agreement also covers services and addresses the harmonization of a range of nontariff measures that affect the free flow of goods and services—including those related to quarantine and customs issues, standards, and business laws. The tangible economic results that Australia has seen from such arrangements have helped increase domestic support for policies with an increasingly global focus. (Australia has also benefited from peer reviews through international comparisons, particularly through the work of the OECD and the International Monetary Fund's article IV process).

Reforms of domestic economic policies

Reforms of Australia's domestic economic policies have been invaluable in repositioning the economy to allow for maximum exploitation of the benefits of globalization. The forward-looking medium-term framework now in place for fiscal policy and monetary policy means that each is anchored by a clear primary objective that it is best suited to achieving: fiscal policy to ensure adequate public saving, and monetary policy to maintain low inflation.

Thus macroeconomic policy is directed at keeping the economy growing at a strong but sustainable rate—avoiding excess demand pressures that would create inflation and widen the current account deficit. This approach is essential to sustain economic expansion and avoid the boom-bust cycle that has plagued Australia, contributing to higher unemployment in the 1980s and early 1990s (see below).

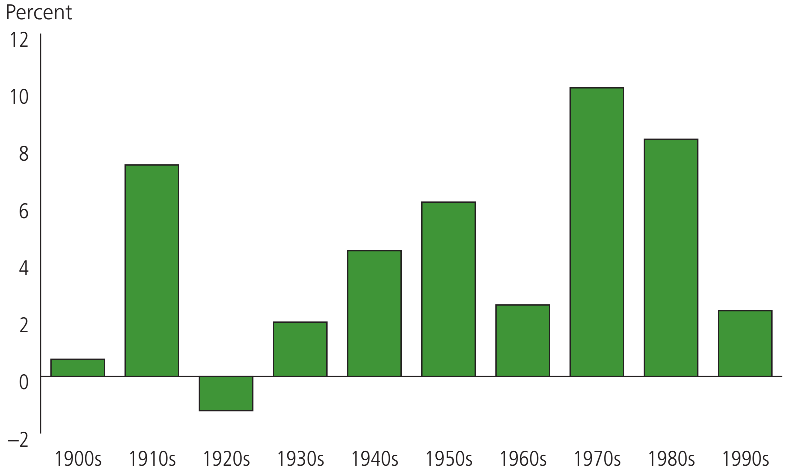
Developments in key macroeconomic policy variables

Until the early 1990s Australia's economic performance was constrained by the tendency for inflation and current account pressures to emerge after even brief periods of strong economic growth. Policy periodically allowed—or even contributed to—the emergence of excess demand pressures. Subsequent policy tightening to control rising inflation and current account deficits contributed to short-term economic downturns. Policy was occasionally reactive, short term in its focus, and unclear in its objectives.

Fiscal policy. To ensure the transparency and accountability of its finances, Australia's federal government now operates under the 1998 Charter of Budget Honesty Act (see http://www.treasury.gov.au for the complete charter). The charter requires the government to present its long-term fiscal strategy with each budget, along with short-term fiscal objectives and targets. The government must also explain the broad strategic priorities on which the budget is based and specify the key fiscal measures against which fiscal policy will be assessed.

The charter also requires comprehensive economic and fiscal outlook reports to be released at the time of each budget, at mid-year, and within 10 days of the issuing of a writ for a general election. Among other things, these reports must contain fiscal estimates for the current budget year and following three fiscal years, the economic and other assumptions

Figure 6. Average annual inflation in Australia, 1900s–1990s



Source: Australian Bureau of Statistics 2001a; Butlin 1962.

used in preparing those estimates, and a statement of risks that may have material effects on the fiscal outlook.

In addition, the charter requires the preparation of an intergenerational report to assess the long-term sustainability of current government policies over a 40-year period, taking into account the financial implications of demographic changes. The report is to be reviewed every five years.

The government retains necessary policy flexibility within this framework. The medium-term strategy was formulated partly in response to a perceived structural deterioration in the current account deficit, associated with a decline in public saving. The strategy aims to achieve budget balance, on average, over the course of the economic cycle—reducing the government's direct contribution to the current account deficit through ongoing budget deficits.

This fiscal policy framework has significantly improved Australia's fiscal position and contributed to its strong economic performance in recent years. In 2000–01 and 2001–02 expansionary fiscal policy supported the domestic economy in the face of a weaker international environment. The medium-term fiscal strategy allows fiscal policy to respond to short-term economic fluctuations and since 2000 has helped Australia maintain solid economic growth relative to other industrial countries. Since 1995–96 the Australian government's general net debt has fallen from 23 percent of GDP to 7 percent, compared with an OECD average of about 44 percent in 2000.

Monetary policy. The Reserve Bank of Australia's charter requires that it exercise monetary policy in a way that contributes to the stability of the Australian dollar, to the maintenance of full employment, and to the economic prosperity and welfare of the Australian people. Since 1993 these objectives have found practical expression in an inflation target, with the bank seeking to limit annual inflation to 2–3 percent over the 10-year economic cycle (figure 6). This target is the centerpiece of the monetary policy framework. It guides decisionmaking on monetary policy and provides an anchor for private sector inflation expectations.

This objective was formalized in the 1996 Statement on the Conduct of Monetary Policy, issued by the treasurer and by the governor of the Reserve Bank. This agreement also ensured the bank's operational independence from the government. With this independence, however, comes the need for transparency and accountability.

The bank's conduct of monetary policy is explained through several channels. It publicly announces any policy change, giving detailed reasons for it. In addition, each year it publishes four statements on monetary policy, which contain detailed analysis of the economy and financial markets and an account of the considerations for the policies adopted by the bank. The bank's governor also appears twice a year before a parliamentary committee to answer questions about bank policies.

Australia's experience shows that reintegration with the global economy need not come at the cost of increased volatility in the domestic economy. Variance in Australian GDP over the economic cycle has declined markedly over the four economic cycles of the past 40 years (Simon 2001). This is partly because the increasingly diversified Australian economy is more resilient to any single shock to the terms of trade, and partly because recent external shocks have not been as large as they once were (for example, the oil price shocks of the 1970s). Improving the arrangements for fiscal and monetary policies and setting them in a medium-term framework have also helped stabilize the economy.

Microeconomic reforms

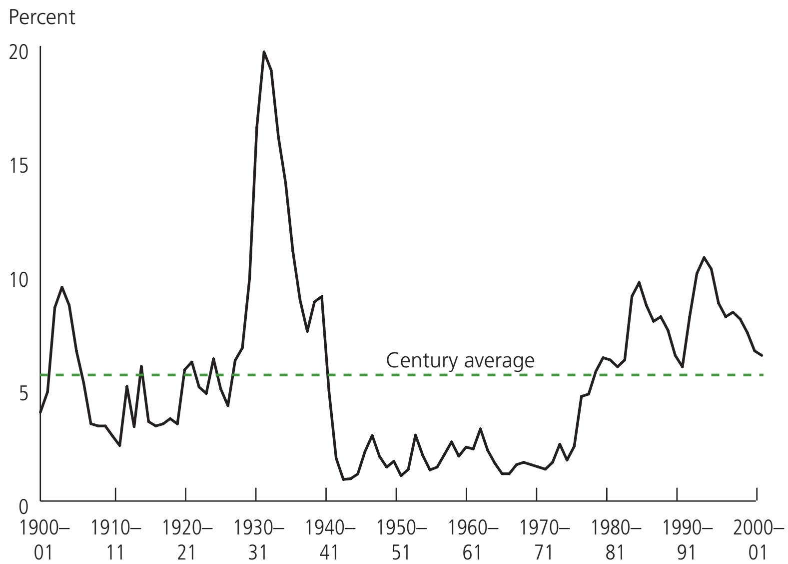
Structural reforms increase economic efficiency by making an economy more competitive and dynamic and by removing distortions that misallocate resources. Australia has made significant microeconomic reforms over the past 20 years—and while the reform process is never complete, Australia has in recent years enjoyed the benefits of a stronger, growing economy that is more flexible, adaptable, and resistant to external economic shocks. Reforms have been particularly notable in labor markets, competition policy, the financial sector, and the tax system.

Labor markets. For most of the 20th century successive governments obligated employers to pass on to employees the benefits of Australia's comprehensive protectionist measures, with arbitrated wages and working conditions resulting from national wage cases. This led to a system of national wage regulation, with arbitrated wages based on "awards" in wage cases that varied according to price movements and judgments about the economywide capacity to pay. There was little room for market forces.

Reforms to workplace arrangements, labor market regulation, and wage arbitration assistance began in the mid-1980s. More decentralized wage setting became a necessary part of market opening, and particularly important once the exchange rate was floated in 1983. It became increasingly evident that the tension between international economic pressures and centralized wage setting was hampering productivity and economic growth.

Both major political parties argued for a shift to a decentralized enterprise bargaining system make the labor market more responsive to changes in the economy and to reduce impediments to job creation, employment participation, and productivity growth. Combined with other reforms and solid economic growth, these labor market reforms have contributed to a significant and sustained reduction in unemployment, particularly since the early 1990s (figure 7).

Figure 7. Unemployment in Australia, 1901–2001



Source: Reserve Bank of Australia data; Australian Bureau of Statistics 2001c.

Another labor market reform was the enactment of the Workplace Relations Act in 1996, which helped link remuneration more closely to enterprise performance and which appears to have contributed to productivity growth (OECD 2000, January, pp. 86–99). During the second half of the 1990s productivity growth rates reached levels not seen since the late 1960s. The increase in productivity growth has been particularly noteworthy because it has occurred across all measures of productivity—labor, capital, and multifactor (table 1). Only a handful of OECD economies have experienced such improvements; most have instead seen a continuous slowdown in productivity. Indeed, in the second half of the 1990s Australia's productivity growth rates exceeded those of the United States.

Competition policy. The overall aim of structural reform has been to increase productivity

TABLE 1
Average annual productivity growth in Australia, mid-1960s–1990s
(percent)

Decade	Labor	Capital	Multifactor
1970s	2.8	–1.0	1.4
1980s	1.4	–1.2	0.4
1990s	2.8	–0.4	1.5
1995–99	3.5	–0.2	2.0
Long-term average (1964–99)	2.3	–0.9	1.1

Source: Australian Bureau of Statistics 2000a.

growth in the Australian economy by reducing structural rigidities and developing and maintaining a competitive market environment. The low productivity rates that Australia experienced in the 1970s and early 1980s—relative to previous decades and those of other countries—gave impetus to competition policy reform. (In 1993 an Independent Committee of Inquiry into National Competition, known as the Hilmer Committee, reported that low productivity in infrastructure industries was one reason Australia's per capita growth rate was below the OECD average in the three decades preceding the 1990s.)

The substantive removal of tariffs and quotas, which reduced barriers to foreign trade, was accompanied by reforms aimed at increasing competition in the nontradables sector. These reforms were intended to ensure that government businesses and privatized public monopolies did not enjoy unfair advantages over their competitors. Sectors previously dominated by government-owned monopolies—such as communications and utilities—have been a primary focus of reform, and have experienced very rapid productivity growth.

Moreover, the sectors where reforms have generated the strongest productivity gains are among those with the most pervasive downstream effects on the costs and global competitiveness of other industries. This provides a reminder of the superiority of pursuing policies that capitalize on gains from reforms and compensate the losers, rather than compromising reforms.

As recommended by the Hilmer Committee's 1993 report, in 1995 the federal and state governments agreed to implement the National Competition Policy. This policy involved introducing competition in areas dominated by public sector infrastructure and systematically reviewing legislation that restricted competition.

The Productivity Commission has estimated that reforms related to the National Competition Policy could eventually increase GDP by 2.5 percent. The commission has also estimated that, by increasing export competitiveness, the reforms will raise exports by 3.4 percent (Productivity Commission 1999a).

Financial sector. Prior to the formation of the Australian Prudential Regulation Authority in 1998, prudential regulation of the financial sector was segmented, with a range of federal and state authorities responsible for supervising different types of financial institutions. In the 1970s and part of the 1980s an oligopoly of large, domestically owned banks was protected from foreign and new domestic competition by a policy of not granting new bank licenses. This policy resulted in a burgeoning nonbank sector that was subject to less regulation. But during the 1980s the Australian banking system was transformed—from one consisting of a small number of major banks, four state banks, and a large number of credit unions and building societies to one where the major banks still dominate, but there are now more smaller banks and open entry into banking.

In the 1980s financial sector reforms liberalized reserve requirements for domestic banks, enabling them to strengthen their competitive position relative to nonbanks and incoming foreign banks—and so increasing their market share. Reforms also removed maturity restrictions on bank deposits and ceilings on interest rates for deposits and loans.

These reforms dramatically liberalized the banking sector. A marked expansion in the operations of foreign-owned banks further broadened and deepened capital markets and spurred improvements in the allocative efficiency of funds. In addition, competition and new technology led to more sophisticated financial services.

In the second half of the 1980s bank loans increased considerably. Growth in outstanding loans increased from 13 percent in 1984 to nearly 21 percent in 1989, and there was a switch in borrowers from the public to the private sector as huge investments in real estate occurred. This growth had many causes, including:

- Competition and deregulation, which made banks more willing to lend.
- Salary and promotion structures within banks that rewarded the development of new business.
- An increase in liquidity, even though interest rates were high.

- Asset price inflation and a taxation system that encouraged borrowing in such circumstances.

As a result, following monetary tightening in 1988, the level of nonperforming loans soared, and two smaller banks experienced financial difficulties that necessitated direct support from their state government owners. These two banks were later incorporated into larger banks. Two of Australia's largest banks also incurred large losses.

These commercial problems were gradually worked out of the system, but there was a continuing sense that the financial sector was evolving too quickly, with a breakdown in traditional barriers between different types of financial intermediaries potentially limiting traditional, institutionally specific forms of supervision. A Financial System Inquiry initiated in 1996 led to the reworking of financial sector regulation, with the creation at the federal level of two functional—rather than sectoral—regulators: the Prudential Regulation Authority for prudential supervision and the Securities and Investments Commission for investor and consumer protection.

In addition, the Reserve Bank's role was strengthened and redefined to independently focus on monetary policy, overall financial system stability, and regulation of the payments system. Finally, wide-ranging corporate governance reforms have been implemented through the Corporate Law Economic Reform Program, covering issues such as takeovers, fundraising, directors' duties, accounting standards, financial product markets, clearing and settlement facilities, and the distribution of financial products.

Tax system. Until recently the tax system in Australia dated from wartime revenue needs and relied on unusual features, including a single-stage sales tax on goods collected at the wholesale level. As the importance of services in the economy increased and channels of distribution changed, it became clear that revenue security was being undermined by the relative decline in the base of the wholesale sales tax. Moreover, there were many different indirect tax rates, which created allocative inefficiency and classification problems.

Marginal effective direct tax rates were high for many low-income earners because the rates interacted with income-tested targeting of social welfare payments, creating unemployment traps and poverty traps. Moreover, the highest marginal income tax rates came into effect at relatively modest income levels, raising further concerns about equity, distortions in people's decisions on whether to pursue work, and disincentives to savings.

Another concern was the growing fiscal imbalance between the federal and state governments. The federal government raised revenue from the main tax bases linked to economic activity, and distributed much of that revenue to states for local spending.

In 1998 the federal government announced plans for a major overhaul of the tax system, the main features of which were:

- Introducing a 10 percent tax on the consumption of most goods and services.
- Abolishing the wholesale sales tax and various minor indirect taxes.
- Replacing grants to states with revenue from the goods and services tax.
- Reducing income tax rates by changing tax brackets, causing marginal and average income tax rates to decline for most Australians.

In addition, in 1999 the government announced a range of changes to the business tax regime. These included:

- Reducing the company tax rate from 36 percent to 30 percent.
- Reducing the capital gains tax for individuals.
- Improving venture capital and scrip-for-scrip measures to assist startup and innovative enterprises.

These reforms, which went into effect in July 2000, have led to a broadly based tax system that provides a more competitive, robust foundation in the face of increasing global competition for investment (OECD 2000, January, pp. 121–25).

Policies to support investments in human capital

Australia's efforts to promote human capital development are perhaps best seen in three key areas: health care, education, and research and development. In addition, the government provides a comprehensive social safety net.

Health care. Australia has a compulsory national health care scheme, called Medicare, run by the federal government. This scheme, introduced in 1984, aims to provide all Australian residents with access to essential, high-quality health care, with priority based on clinical need. It provides rebates for a large portion of general and specialist medical fees, as well as hospital care. Pharmaceutical drugs are also subsidized. (For a detailed discussion of the health care system, see OECD 1995, May, pp. 71–114, or http://www.health.gov.au).

Health care spending as a share of national income is around the OECD average, and in recent decades the health status of Australians has improved significantly. The system promises universal coverage through a blend of public and private arrangements for the funding and provision of medical services.

Education. While there is no central government system of primary and secondary education in Australia, there are few significant differences among state systems—and over the past decade in particular, state governments have worked to further standardize their systems. Education is compulsory between the ages of 6 and 15, and about three-quarters of students complete grade 12, the final year of secondary education—twice the proportion of 1980. In addition to the public education system, there are numerous private (nongovernment) schools, training organizations, and community education providers, which receive varying levels of government funding (Australian Bureau of Statistics 1999b). (For a detailed discussion of the education system, see OECD 1996, December, pp. 130–57.)

Substantial changes have occurred in the Australian system for post-compulsory education and training in response to the deteriorating labor market prospects of low-skilled workers and the need to improve the international competitiveness of Australian industries. Australia's tertiary education sector comprises universities, colleges of technical and further education, and private and community vocational education providers. In the 1980s tertiary institutions were encouraged to consolidate in an effort to increase efficiency. The number of universities was halved, student places increased by half, and total spending rose considerably.

Universities were also expected to earn more revenue from other sources, such as consulting, designated research, foreign students paying full fees, and commercial activities. The partial deregulation of the tertiary sector opened up previously unexploited export markets, as many universities looked to Asia in search of fee-paying students. By 1993 a number of universities were among Australia's top 500 export earners.

In addition, vocational training has been reorganized to extend entry-level training to a wider range of enterprises, in an effort to maximize its workforce relevance and introduce competition in its provision.

Research and development. Another policy initiative aimed at capitalizing on Australia's re-entry into the global arena involves research and development. The A$2.9 billion Backing Australia's Ability program, announced in 2001, aims to complement the achievement of fiscal responsibility and macroeconomic and structural reforms, and to support and encourage innovative activities. The program has provided funding to encourage quality research and development and to upgrade university research facilities. Through a network of cooperative research centers, there is also a drive to link universities with businesses, enabling the commercialization of new technologies and developments (see http://www.itr.gov.au).

Social safety net. Australia has long had a comprehensive social safety net. Unemployment benefits are funded from general tax revenue rather than employment-based levies, and are paid at a flat rate intended to alleviate poverty rather than maintain previous income levels. Payments are targeted to people in need through the application of income and asset tests.

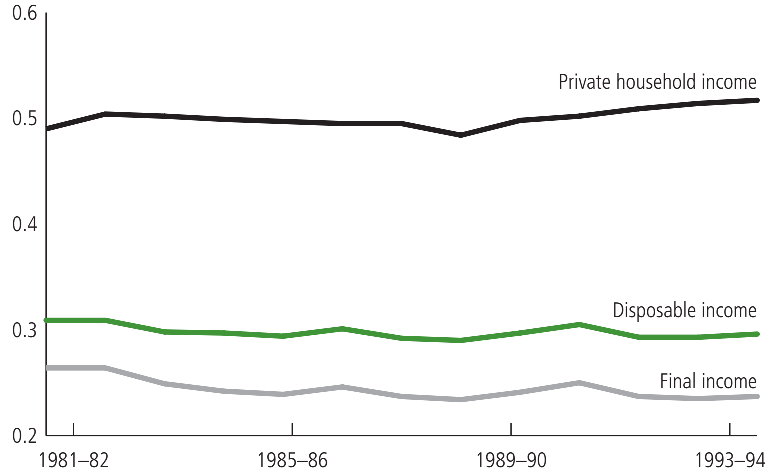
The retirement income system comprises a publicly provided, means-tested old age pension, mandatory private superannuation savings, and voluntary savings (including voluntary superannuation savings). Australia has had a publicly provided old age pension system since 1908. It has retained its original character of a targeted benefit provided on the basis of need, as determined by income and asset tests. Because it provides a basic standard of living to people most in need, rather than maintaining pre-retirement income, it remains affordable for the government. Indeed, the Australian system is increasingly seen as a model for other countries. World Bank (1994), for example, finds that the Australian model offers the best prospects for simultaneously improving national saving, ensuring intergenerational equity, providing higher incomes in retirement, and being fiscally sustainable in an environment where the population is aging.

Retirement incomes above the level of the publicly provided pension depend on self-provision. This includes mandatory savings through the superannuation contribution scheme, introduced in the early 1990s, and voluntary savings through superannuation and accumulation of other assets such as the family home, other property, and investments.

Poverty rates (as measured against a relative poverty line) have declined slightly over the past two decades, from 14.6 percent of Australians in 1982 to 13.3 percent in 1999 (for a description of poverty measures and rates, see Australian Bureau of Statistics 2001b). Moreover, when taxes and transfers are taken into account, the living standards of low-income earners increased substantially between the early 1980s and mid-1990s—despite a slight widening in the pretax distribution of wages and earnings in the early 1990s (figure 8). And though the Gini coefficient fluctuated somewhat during the intervening years, in both 1994–95 and 1997–98 it was stable at 0.32 (Australian Bureau of Statistics 2001b).

Unemployment, rather than low wages, is the main cause of low income levels. Thus the importance of lowering unemployment to lower poverty has contributed to successive governments' strong emphasis on sound macroeconomic and microeconomic reforms, to raise Australia's growth potential and reduce unemployment.

Figure 8. Gini coefficients for real equivalized household incomes in Australia, 1981–94



Source: Johnson, Manning, and others 1995.

Sequencing of domestic reforms relative to market opening reforms

Although reductions in protectionism commenced in the 1970s and core financial sector reforms were implemented relatively rapidly in the 1980s, the broad range of reforms in other areas was not carried out in a predetermined sequence. As the Productivity Commission (1999b, p. 18) noted: "implementation of reform over time was governed by a number of competing factors:

- there was some prior knowledge of major policies that warranted reform;
- new reform areas and priorities emerged after some reforms were implemented and revealed other structural weaknesses in the economy;
- industry protection in some industries was locked-in for periods under long-term arrangements; and
- there were political pressures and social considerations about the pace and direction of reforms.

As a result, reform did not proceed according to a predetermined blueprint or timetable … and although calls came from a number of quarters for a broad range of reforms to be implemented in close succession or in optimal sequence, reforms in Australia were implemented gradually, sequentially in a number of important respects, and in an order determined in part by opportunity and political judgement."

Interaction between market opening and social, legal, and economic institutions

Australia was fortunate that its basic social, legal, and economic institutions were well developed before the reforms of the 1970s–90s. Even so, reforms to industry structure and labor markets can take decades to take effect, while financial sector changes can have effects very quickly. The financial sector deregulation of the early to mid-1980s contributed to a deterioration in loan quality, several corporate collapses, and some forced mergers of minor banks. Had prudential supervision and corporate governance arrangements been reformed earlier in the process of reglobalization, those transitional costs might have been reduced. That said, the stresses that did arise were dealt with quickly and without resort to unnecessary regulation.

General conclusions are hard to draw because every country's circumstances differ. Australia's experience does not suggest that reforms should wait for perfect sequencing according to some preconceived blueprint. Sometimes the opportunities for rapid reform must be seized whenever political circumstances allow. But clearly, financial deregulation places particular weight on good financial data, good corporate governance, and good prudential supervision.

Assessment: benefits and challenges of globalization

Though globalization offers many potential benefits, it also poses serious challenges. Successful globalization requires that both be carefully considered. In addition, international institutions have a role to play in facilitating reforms.

Benefits

Australia has received large and dramatic benefits from globalization. The reintegration of the Australian economy with the global economy over the past 30 years has significantly improved economic performance, enhancing living standards. After many years of reform, Australia has developed a vibrant, flexible, outward-looking economy that has proven resilient to the shocks of the East Asian financial crisis in the late 1990s and the current global slowdown. By 2000 per capita GDP was around A$1,900—6 percent higher than if Australia had grown in the 1990s at the average rate of the 1980s (Parkinson 2001).

Despite weak global economic conditions, the Australian economy strengthened in 2001. It also remained solid in the first half of 2002, with 3.8 percent annualized growth. In 2001–02 Australia's economy was among the strongest in the industrial world.

Challenges

At each stage of Australia's reform process, change has led to vocal criticism—particularly in areas such as reducing industry protection, decentralizing labor markets, and privatizing public enterprises, where changes were extensive, vested interests were strong, and payoffs from reform were not immediate.

There has been a tendency to take for granted the higher incomes and improved economic performance of the past decade, and to dissociate them from the policy changes that made them possible. There are also concerns that traditional areas of employment have declined, that large parts of the labor force have suffered losses, that there is more uncertainty about the future, that earnings differentials have widened, and that successful Australian companies may in the future move offshore or otherwise reduce their links to Australia.

These concerns point to a need to better explain, to a wider audience, that:

- Australia's reglobalization has followed from domestic reforms—not just from international trends—and has led to better living standards.
- Better policies have helped reduce the volatility of GDP despite closer international economic integration and deregulated financial markets.
- Taxes and transfers have reduced the effect on inequality of the widening earnings distribution.

- Changing work patterns have been driven not just by globalization, but also in response to extensive social changes such as higher female participation in the workforce and extended periods of study and retraining.

Role of international institutions in facilitating reforms

International institutions have played a role in Australia's reform process by exposing policymakers to other countries' best policy practices (for example, through the International Monetary Fund's article IV process and through general IMF and OECD analytical work). Peer reviews of Australian policies (through the OECD) and international chronicling of Australia's relative economic performance have also been beneficial.

Notes

1. Smeeding (2002) reports a modest rise in Australian income inequality over the past 10 years. But the Australian Bureau of Statistics recently reported that there has been no significant change in income distribution across income quintiles since 1994–95 (see http://www.abs.gov.au). Similarly, the Gini coefficient has not changed significantly in this more recent period.

2. Generally speaking, foreign investment policy is nonrestrictive. But the treasurer does have legislative authority to veto or restrict investment if it is "contrary to the national interest". The government decides what is contrary to the national interest based on the concerns of the general public. Thus restrictions on foreign investment are stronger in sensitive areas such as the media and developed residential real estate. Regulation is governed by the Foreign Acquisitions and Takeovers Act of 1975 (see http://www.firb.gov.au).

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Brazil

Preparing Brazil for competing in the global economy has been one of the major objectives of economic policy. But it has not been the only one—indeed, it has not been the most important one. In a country with low social indicators, most of them related to unequal income distribution, the main target of economic policy is to achieve sustained growth leading to a higher per capita product and better distribution of income. So several measures have been aimed at internal goals, even though they may have concurrently fostered the Brazilian competitive presence at the international level. Inflation, fiscal balance, and flexible exchange rate, for instance, may be listed under this category, side by side with social policies that sharply reduced infant mortality and illiteracy and increased life expectancy. In some areas (education and infant mortality, for instance), Brazil has reached targets set by the Millennium Development Goals. But in other areas (such as health) much remains to be done.

Recent policymaking has given Brazil a stable and predictable fiscal and monetary framework. Some of the main results:

- Inflation has been brought down from three digits (even four digits) to less than 10 percent. With rigorous control of public expenditures and increased tax collection, along with innovative legislation aiming at fiscal accountability, Brazil has enjoyed 18 quarters of primary surplus in a row, currently around 4.5 percent of GDP.
- Average economic growth from 1995 to 2000, at about 2.9 percent of GDP, was higher than the 0.6 percent in the six previous years. It then reached 4.6 percent in 2002, but fell to 1.5 percent in 2001. For 2003 growth is estimated at 2.0 percent.
- Exports and imports in GDP reached only 18.8 percent in 2001; even though this is the highest level since 1985, the share of trade in GDP has been historically low—around 13–14 percent, with exports usually below 10 percent and imports below 7 percent.
- Average tariffs fell from 51 percent in 1988 to 11.7 percent in January 2002.
- The trade balance evolved from a deficit of \$6.6 billion in 1998 to a surplus of \$17 billion in the last twelve months ending April 2003.
- Foreign direct investment amounted to \$24.7 billion in 2001, covering the deficit in current account of \$23.21, and to \$143 billion for 1995–2001.
- Net external debt was \$163 billion in 2001, half of it private, with no short-term public debt.

Economic measures implemented within the stabilization plan fostered Brazil's competitive presence in international markets, providing economic gains to the Brazilian people. Macroeconomic measures were marked by credibility and consistency, greatly enhancing transparency and strengthening institutional structures. And policies to address problems of income disparities have become more effective.

But globalization has not induced consistent growth of real GDP per capita over time, at the same pace as growth in foreign trade (despite lower tariffs). Nor has it increased the share of manufactured goods in total exports, even though exports of manufactured goods have increased both in volume and in amount. Globalization may have contributed to a higher dependence on volatile short-term capital (ranging from minus \$400 million to plus \$54 billion during 1989–2001) and to higher unemployment (which has risen in years of higher participation of foreign trade in the GDP). And it may even have led to a more perverse concentration of income (the Gini index rose from 59.6 in 1990 to 60.9 in 2000).

Liberalizing trade flows

The rationale for trade openness in Brazil has been to optimize production and to maximize benefits of returns to scale and scope. Recent improvements in global transportation and communication, associated with technological change and market opening, broadened the division of labor and fostered competition. In Brazil, newly found competition has ensured that benefits of increased efficiency be passed on to consumers, in the form of both lower prices and higher quality. The reduction of tariffs over the last 15 years has played an important role in the process.

Important changes were introduced in Brazil's industrial development policy in the late 1980s. To make Brazilian industry competitive and to convert tariffs into an industrial development policy instrument, several reforms were introduced to the Brazilian tariff structure in July 1988. As a result of those reforms, the average rate of import tax on overall imports was reduced from 51 percent on June 30 1988 to 41 percent on July 1, 1988, with the peak tariff reduced from 105 percent to 85 percent. Despite the sharp reduction, Brazilian imports remained at the same level, due to the maintenance of high import tax rates and the maintenance of other barriers.

Starting in 1990, deeper reforms were introduced, such as the elimination of all restrictions to processed and semi-processed import goods and the further reduction of tariffs. In the aftermath of those reforms, the average tariff decreased from 32.2 percent in 1990 to 25.3 percent in 1991, 16.5 percent in 1992, and to 14.3 percent from July 1, 1993 to December 31, 1994. The peak was reduced from 85 percent in 1991 to 55 percent in 1992 and to 40 percent from July 1, 1993 to December 31, 1994.

Mercosul's Common External Tariff (CET) contributed to further reductions of Brazilian tariffs. The average tariff decreased to 12.6 percent in January 1995, followed by further decreases in October 1995 (to 11.2 percent) and in January 1996, remaining at 11.1 percent until November 1997. In that month, Decree no. 2,376/97 imposed a linear increase of 3 percent on all tariffs, which raised the average to 13.8 percent. From January 1995 to November 1997, the tariffs ranged from 0 percent to 20 percent. From November 1997 to December 2000, the tariff structure remained untouched, even though a few items were added to the list. During this period, the average remained at 13.8 percent, the modal tariff at 17 percent, and the median tariff fluctuated between 15 percent and 17 percent.

On January 1, 2001, Decree no. 3,704 came into force, introducing changes in the CET in order to deduct 0.5 percent from the 3 percent that had been added in November 1997. As a result, the average tariff was reduced to 12.9 percent, the amplitude ranged from 0 percent to 22.5 percent, and the modal tariff decreased to 4.5 percent and the median to 14 percent. But the reduction was short-lived. In March 2001, changes introduced in the automobile regime of MERCOSUL (Resolution CAMEX no. 7, dated March 22, 2001) increased the CET to 35 percent for the import of vehicles listed under Chapter 87 of Mercosul's Common Nomenclature. So those products were excluded from the list of exceptions, and the amplitude was enlarged from 0 percent to 35 percent. Even though the modal and median tariffs remained at the same level as in 1997 (4.5 percent and 14 percent), the average tariff increased to 13 percent. On January 1, 2002, the new CET entered in force and Resolution CAMEX no. 42, dated December 26, 2001, not only transferred tariffs to the Harmonized System of 2002 but also deducted an additional 1.5 percent from the 3 percent that had been added in November 1997. As of January 1, 2002, the CET covers 9,623 items with an amplitude ranging from 0 percent to 35 percent and an average tariff of 11.7 percent.

The average, median and modal tariffs mentioned above do not take into consideration the 974 items included in the exception list (557 in medicines and drugs, 317 in computer and telecommunication goods, and 100 in miscellaneous goods).

With the multilateral negotiations under GATT's Uruguay Round, Brazil committed not to impose tariffs on industrialized goods higher than 35 percent ad valorem from January 1, 1999 onwards. From January 1, 1995 to January 1, 1999, tariffs in effect in 1986 (when the Uruguay Round was launched) had to be gradually reduced, in equal installments, to the ceiling of 35 percent. In this way, for a given industrialized good, such as passenger cars (tariff of 105 percent in 1986), Brazil committed not to increase tariffs above the following ceilings: 91 percent in 1995, 77 percent in 1996, 63 percent in 1997, 49 percent in 1998, and 35 percent in 1999. For goods protected by tariffs below or equal to 35 percent at the time negotiations were engaged within Uruguay Round, not included in the former list of concessions in GATT, the consolidation of 35 percent entered in force automatically as of January 1, 1995. Tariffs below 35 percent included in the former list of concessions had been preserved.

For agribusiness, the Agriculture Agreement negotiated in the Uruguay Round led to the consolidation and reduction of all tariffs over the implementation period. To do so, all nontariff barriers were converted into tariffs. For developing countries, reductions were at least 24 percent on average over a period of ten years. Brazil consolidated a ceiling of 55 percent for agriculture products (today, a tariff of this magnitude is imposed only on rice and processed peaches).

The initiative of opening the Brazilian market to trade was aimed at improving the efficiency of the industry, by exposing its different segments to external competition. This policy was supported by measures to modernize Brazilian industry, such as the temporary reduction of tariffs imposed on machinery, equipment, and spare parts.

Both and progressive reduction of tariffs and the elimination of other instruments to limit imports led to the use of other resources authorized by the GATT/WTO to protect Brazilian companies. Since 1991 Brazil has effectively used anti-dumping and compensatory measures, by promoting several processes of investigation on anti-dumping and illegal subsidies measures practiced by its trade partners.

Strengthening the financial system

The globalization in trade has been a gradual process through the mechanism of economic blocs. But the financial sector can already be viewed as a global village, with currency a global commodity. According to estimates, $11 trillion are flowing unendingly from one corner of the globe to another in search of higher profits, no matter the language.

Globalization has reached deeply in the Brazil, which has the largest and probably the most complex financial system in Latin America, a system that has developed in the context of high inflation over the past 30 years. The institutional reforms and important legal and normative changes in this period were largely generated by efforts to combat inflation. The long period of coexistence with inflation produced a situation in which the gains generated by noninterest bearing liabilities, such as demand deposits and deposits in transit, compensated for administrative inefficiencies and even for the granting of credits of doubtful return.

With the new price stability in Brazil after many failed attempts, the adjustments required for survival in the global economic environment were beyond the capacity of Brazilian financial institutions. In a universe of 265 banks, with more than 16,000 branches and 11,000 service outlets, many institutions have gone under, generating enormous financial and social costs.

The Brazilian government is fully aware that the most valued asset of the banking industry is its credibility. A run on the banks can result from a loss of credibility at just a few institutions. Such an event would have a domino effect, generating grave problems for all banks and even for productive sectors of the economy. But solutions based on such special mechanisms as intervention, liquidation and temporary administration as permitted by legislation have a social cost that is much higher than measures taken beforehand with the aim of transferring control of the institutions to more efficient hands.

The steps in Provisional Measure no. 1,179 and Resolution no. 2,208, both of which were issued on November 3, 1995, introduced the Program of Incentives to the Restructuring and Strengthening of the National Financial System (Proer) to mandate bank mergers and incorporations, based on rules set down by the Central Bank. This system, which followed closely upon the crisis involving the Banco Económico—the 22nd bank to be subjected to intervention/liquidation since implementation of the Real Plan in 1994—was viewed as a means of resolving problems before they appeared and facilitating the process of National Financial System adjustment. With Proer, society's investments and savings are guaranteed. National Monetary Council Resolutions no. 2,197, dated August 31, 1995, and no. 2,211, dated November 16, 1995, introduced unconditional adherence to the depositor protection mechanism, thus avoiding the possibility of localized future problems affecting the entire system and society.

Provisional Measure no. 1,182, issued on November 17, 1995, just two weeks after issue of Provisional Measure no. 1,179, gave the Central Bank the legal instruments that it needed to lead the financial system to a new model. Authority was granted to the Central Bank to maintain only healthy financial institutions with the necessary liquidity and solidity. Consequently, even though the responsibilities of the Central Bank were significantly expanded, the institution was finally given the instruments required to overhaul the entire system. With these new instruments, the Central Bank could act preventively and with much greater efficiency. What the Bank was able only to suggest in the past, it can now mandate.

In ten articles, Provisional Measure no. 1,182 creates the concept of the individual responsibility of controllers—applicable also to financial institutions submitted to intervention or extrajudicial liquidation. This concept already existed in the Temporary System of Special Administration. Parallel to this, it extended the concept of the inalienability of property to controlling stockholders and facilitated federal government expropriation of the stocks of institutions in difficult situations for purposes of future privatization. Properties considered by law as inalienable or not subject to lien are excluded from the concept of inalienability. Among them are stocks held by state governments, labor debts, and balances in the Employment Guaranty Fund.

If a situation of equity or financial insufficiency is found, the Central Bank can require capitalization of the financial institution in an amount deemed necessary for its recovery, transfer of stock control, merger, incorporation, or split-up. If the Central Bank's demands are not complied with in the predetermined time period, the monetary authority can decree the special system judged to be suitable to the specific situation at hand (Temporary System of Special Administration, intervention or extrajudicial liquidation).

In cases of intervention, extrajudicial liquidation, or the temporary system of special administration, the Provisional Measure grants the Central Bank autonomy to authorize the intervening party, liquidator, or board of directors to transfer or assign properties and rights to third parties—and to transfer rights and obligations to another company and even to proceed to the stock reorganization of the institution.

When it initiates administrative proceedings against a financial institution, the Central Bank can—for precautionary purposes—remove anyone under indictment until the investigation of responsibilities is concluded. It can also impede indicted administrators from assuming positions of authority or management in financial companies in general. Moreover, the Central Bank can impose restrictions on the activities of these institutions. For example, if it uncovers irregularities in foreign exchange operations, it can forbid the bank from operating in foreign exchange. If the administrative proceedings cannot be concluded within 120 days, any precautionary measures that may have been taken lose their validity.

The federal government may expropriate the shares of banks subject to the Temporary System of Special Administration. In each case, the expropriation decree specifies the time period for the transfer of stock control. The shares will be placed in public offer, with the explicit condition that the institution will remain within the private sector, thus eliminating any possibility of federalization of the bank in question. Even when the process of intervention has come to an end, the Central Bank will still have authority to verify the existence of any irregularities that may have been committed by the controllers of the institution. There is also the possibility of choosing another bank (or other legal entity) to carry out this task.

Today, the specter of a bank crisis in Brazil is no longer the major concern of economic authorities. The efforts made to strengthen the national financial system are of such importance that their success is the key to guarantying the success of the Real Plan. After all, the banks are elements of fundamental importance to sustained economic growth, the Real Plan's overriding goal.

In the opinion of the professionals and executives who now operate on the financial market, the new financial system will be subdivided into three distinct markets: retail (with few and very large institutions), investment (with few and highly agile institutions), and specialized (in vehicle sales, for instance). Current opinion is that the number of institutions will diminish, while the size of the system will increase—since it will have to accompany the process of economic growth and, therefore, will have to provide banking services to a larger array of people and businesses. Also by way of prediction, it is possible that the entire financial system will have been restructured by the coming decade. Aside from the mergers, incorporations, and reductions in the number of banks, there will be a totally new reality in the area of services: cheaper credit for the population.

By means of credit lines, the Central Bank would promote mergers, incorporations, and transfers of stock control as a means of preventing problems before they occur in the Brazilian banking system. For this, the Central Bank has been given new instruments to prevent situations of risk. These measures include punishing and removing administrators and controllers of financial institutions. The idea behind Proer is to generate the least possible cost for the Treasury and for society, while preserving the interests of depositors. The program also involves a deposit insurance system up to a level of R$20,000, thus covering 95 percent of the universe of depositors, precisely those who have less access to information on financial institutions. In this way, these people will be protected in cases of intervention or liquidation.

Uncertain benefits from globalization

Globalization has had an ambiguous impact on the Brazilian economy. Data indicate that Brazil's insertion into the global economy has not induced growth of real GDP per capita. Nor has it increased the participation of manufactured goods in total exports. But it may have contributed to a higher dependence on volatile short-term capital, to higher unemployment rates, and to an even more perverse concentration of income.

Some social indicators have improved noticeably in the last decade: The infant mortality rate is down from 43.0 per 1,000 live births in 1992 to 29.6 in 2000. Life expectancy at birth is up from 66 years in 1992 to 68.6 in 2000. The adult illiteracy rate is down from 17.2 percent in 1992 to 13.3 percent in 2000—and in rural areas from 35.8 percent to 29.0 percent. But other economic and social indicators have not been helped by globalization or by the insertion of Brazil into the global economy.

Analysts may affirm that Brazil's external openness was hurt by the overvaluation of the real from 1994 to early 1999. Even though the share of imports and exports in GDP (as an indicator of trade openness) increased from 14 percent to 19 percent in 1999–2001—that is, after the devaluation of the real—it remained stable from 1987 to 1998, ranging from 11 percent to 16 percent. The fact is that the participation of foreign trade in the Brazilian GDP has not risen significantly, from 1987 to 2001, despite a sharp fall in average tariff from 51 percent to 13 percent. Data suggest that foreign exchange fluctuations may have had a more significant impact on trade openness than reduced tariffs. Contrary to the results in other countries (Mexico, Chile, China, the Republic of Korea, to mention a few), the Brazilian real GDP per capita has not increased consistently in step with growth in foreign trade (figure 1). Either such a relation is not verifiable or Brazil has not

Figure 1. Uncertain benefits from openness

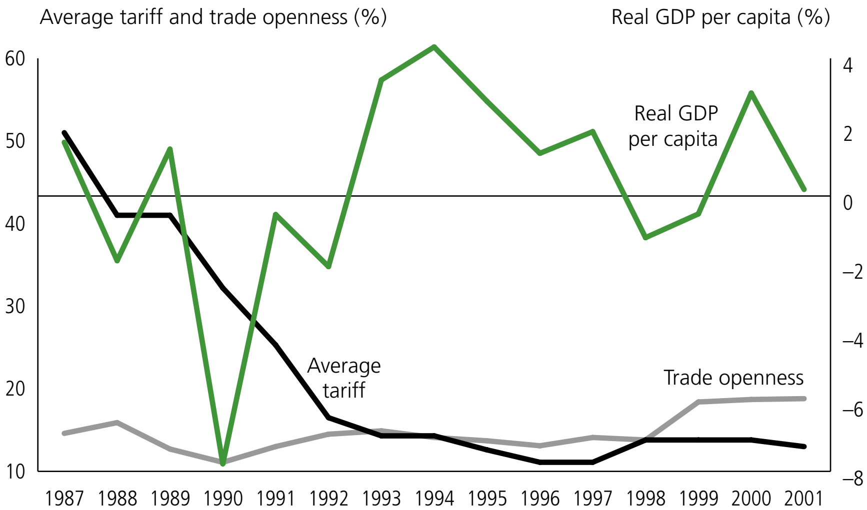
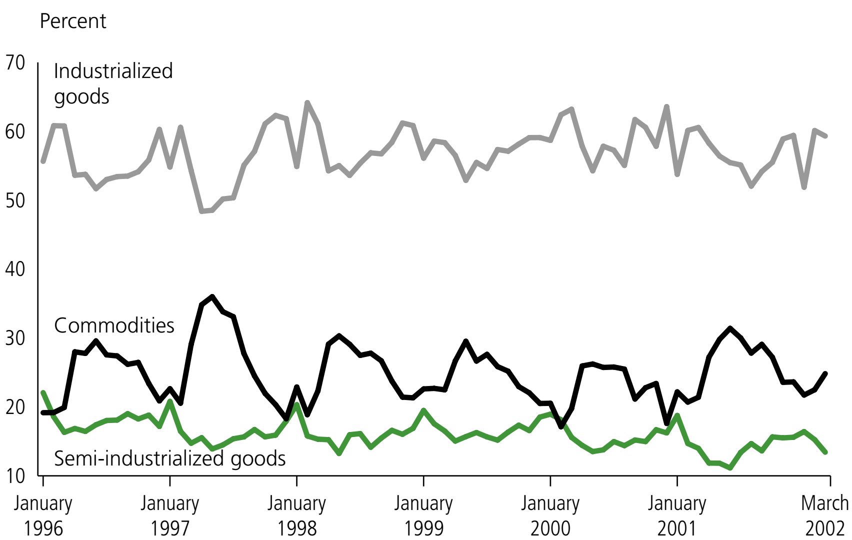


Figure 2. Participation in total exports



been sufficiently exposed to the globalization process to benefit from its advantages.

One might expect that increased openness would entail more participation of manufactured goods exports in total exports. Brazil is among the 10 largest economies in the world and has the largest industry in Latin America. As a result of lower tariffs, a flexible exchange rate, and increased productivity, it would be expected to have exports of manufactured goods rise in relation to GDP. Instead, that share in total exports has remained stable over the last 75 months, at around 55 percent (figure 2).

A negative aspect of financial liberalization is the high volatility of foreign investment in portfolio, and Brazil is no exception. Given steep variations in the exchange and interest rates, foreign investment in portfolio ranged from minus $400 million to plus $54 billion during 1989–2001 (figure 3).

Social implications may also be pointed out. Globalization is too recent a phenomenon to establish a correlation between trade openness and unemployment in Brazil. The unemployment rate has risen in recent years, especially in years of higher participation of foreign trade in the GDP (figure 4). But as it is a relatively closed economy it is not clear that increased openness led to higher unemployment in Brazil. Many other factors may have contributed to unemployment, most of them deriving from stabilization. But the fact that unemployment has not decreased deserves attention whenever the impact of globalization on the Brazilian economy is examined.

Apparently globalization has not mitigated the perverse concentration of income in Brazil. In 1992 the average income of the 10 percent richest people represented 57 times the average income of the 10 percent poorest (and 21 times the average income of the 40 percent poorest), and in 1999, 53 times and 22 times, respectively.

Conclusion

Brazil has gained some of the benefits associated with globalization. It currently enjoys more access to capital, better technology, greater choices of goods, larger markets and economies of scale, and more efficient allocation of resources. But the data suggest that globalization has not contributed to higher growth and income per capita. Nor has it reduced inequality (regional and social) and economic insecurity (volatility in financial markets and economic activity).

The Brazilian experience suggests four major lessons of general applicability in the international community.

First is the importance of macroeconomic policymaking characterized by credibility and consistency, with greater transparency and stronger institutional structures—to insulate the country from external shocks. In Brazil, this policymaking greatly reduced the impact of external shocks. The adoption of an inflation target, the fiscal balance obtained through the implementation of innovative legislation, and the flexible exchange rate preserved the gains attained by stabilization, structural reforms, and strong and effective regulatory framework for financial and capital markets. Transparency was stimulated by enacting laws and by publishing verifiable data, such as the statistics disseminated through IMF's Special Data Dissemination Standard (SDDS).

Second is the necessity of focus on social policies aimed at both reducing income disparities and improving labor market flexibility. Such a focus serves three purposes simultaneously, all converging to higher income per capita and a better distribution of income. It increases productivity by accumulating the "human capital"—that is, investments in education and skills. It also reduces income disparities, enlarging the internal market and providing gains of scope and scale to help domestic companies reduce costs and become more competitive overseas. And it combines social policies with flexible labor markets to protect workers from changes in external consumption patterns and help minimize economic fluctuations, both regional and sectoral. There is still much to do in improving social indicators and making labor markets more flexible. But recent dramatic improvements demonstrate that the country can be competitive in high-technology exports, such as airplanes, by relying on its human resources.

Third, external liberalization in an environment of uncertainty may lead to only partial gains from competing more in the global economy. In Brazil, interdependence can be found in financial and capital flows, but trade relations are still less than they might be, given the magnitude of the economy. Limited exports affect domestic companies both on the supply side (due to the limited inflow of hard currency to pay for imports of equipment and raw material) and on the demand side (circumscribing their reach to the domestic market). By doing so, it prevents them from obtaining gains of scale and scope on international markets. Brazil is not comparable with the Republic of Korea, Mexico, Chile, or China, where one can find a strong correlation between trade openness and increased real GDP per capita.

Fourth, the Brazilian experience stresses the importance of structural reforms to attract FDI—to finance current account deficits and, above all, to complement internal savings to finance growth. This highlights the paramount importance of the state in running the process and in setting out a regulatory and supervision framework to ensure gains for the population. Structural reforms and privatization have not lessened the size of the state. But they changed from an entrepreneurial state to a managerial one. This change inaugurates a more flexible state and releases resources to be invested in social policies.

Figure 3. Net foreign investment in portfolio

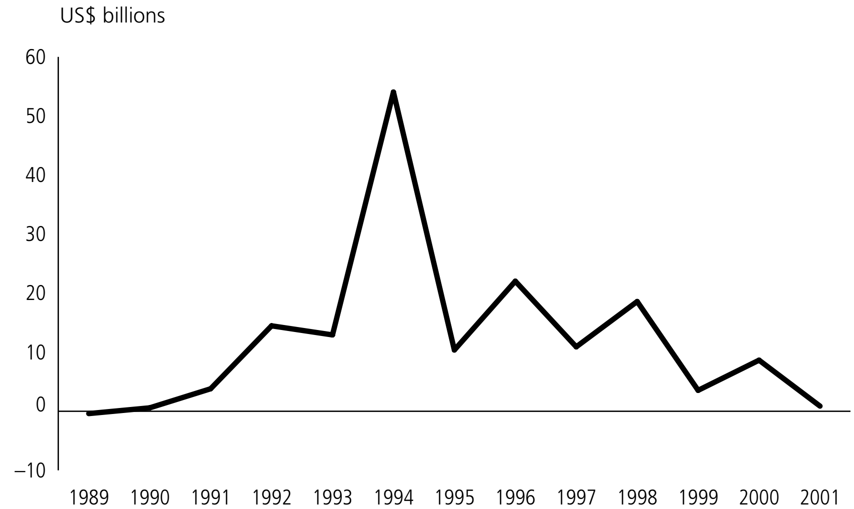
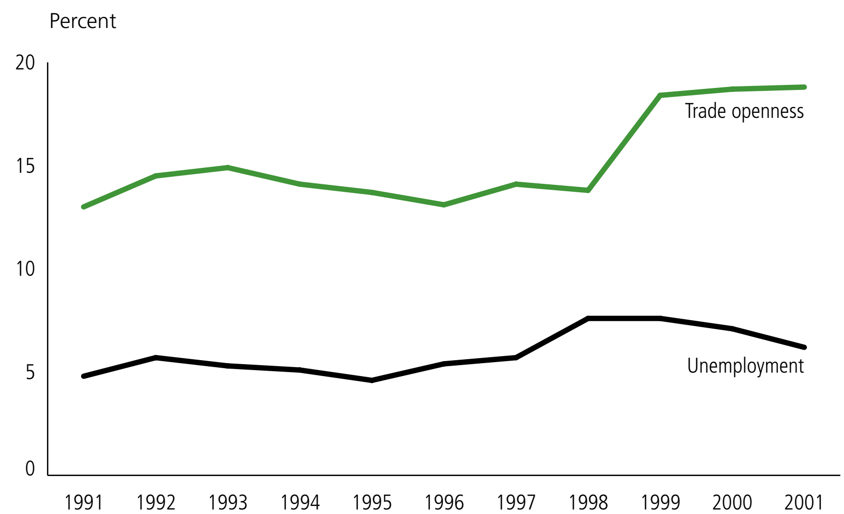


Figure 4. Uncertain relation between unemployment and trade openness



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Canada

International markets for goods, services, and capital have been of critical importance to the Canadian economy throughout its history. Foreign countries represent key markets for Canadian production and sources of capital needed to finance growth and development. An educated and productive labor force, stable and well-developed political and legal systems and institutions, and access to domestic natural resources and to the nearby U.S. market have contributed to Canada's prosperity. In addition, Canada shared in the general expansion of global trade and investment in the decades following the World War II. Solid economic growth provided the means to finance social programs that both reinforced economic performance and provided a high degree of social protection.

Over the last century, changes in the global economy, in particular the steady integration of international financial markets and the increasing competitiveness and pace of change in world markets for goods and services, posed significant challenges for Canadian economic and social policy. They also created new opportunities. Although part of a process under way through much of the postwar period, this trend towards globalization, and the associated need for a policy response, accelerated in the last quarter of the 20th century, especially since the mid-1980s.

This case study looks at Canada's experience in three areas, with particular emphasis on the period since the mid-1980s.

- Market-opening measures, which allowed Canada to expand and consolidate its long-standing orientation toward world markets.
- The interaction between domestic macroeconomic, structural, and social policies and the increasingly globalized international environment.
- The impact of these policy directions in contributing to strong and equitable economic growth and the role of Canada's membership in certain key international institutions in helping create and sustain support for domestic policies in these and other areas.

Canada's external orientation in historical perspective

External trade

Orientation toward global commerce has been of crucial importance to the Canadian economy since long before the country's independence. The first permanent European settlements in what is now Canada were land bases for fishing fleets attracted by the abundant fish stocks of Canada's east coast. Later, the wealth from the fur trade and timber-cutting became a key factor motivating European exploration of the interior of the continent, which in turn created the foundation for later settlement and agricultural and urban development.

In the 19th century, recognition that trade contributes to higher living standards was strong among the British colonies that would later unite to form Canada. This was manifest in the establishment of free trade policies among these colonies, and a "reciprocity" (bilateral trade) arrangement with the United States established in 1854. The termination of this arrangement by the United States in 1866 was arguably an important factor behind Canada's Confederation in 1867. Lack of success in re-establishing this arrangement—combined with an economic depression in the 1870—accentuated protectionist sentiments and led Canada in 1879 to establish a regime of tariff protection known as the "National Policy" (Masters 1963). As in other countries, protectionism gained strength amid the desperation in the Great Depression of the 1930s, notwithstanding the continuation of preferential trading arrangements within the British Empire, and later the Commonwealth.

The period after World War II can thus be viewed as one in which Canada gradually reversed its protectionist policies through multilateral trade liberalization under the auspices of the GATT. As the postwar period progressed, and multilateral trade liberalization began in earnest with the establishment of the GATT in 1947, the focus shifted toward reducing tariffs on manufactured goods. The natural pull of north-south economic forces also led to various bilateral trade arrangements with the United States in particular sectors, most notably in autos through the Auto Pact.

Integration with international capital markets

Access to global capital markets has also played an important role throughout Canada's economic history, providing the capital to finance investment in key sectors. Capital inflows were very important in the late 19th and early 20th centuries. Like other countries then on the periphery of the industrialized world, Canada borrowed externally to finance essential infrastructure investment. The flows during this "first period of globalization", sizable relative to those today, would from a modern perspective be a source of concern.

Openness to international capital flows, in the form of both foreign direct and portfolio investment, remained a key feature of the Canadian economy in the postwar period. While capital controls became common across many industrial countries, Canada maintained a basically open capital account, reflecting the continuing importance of external capital to the financing of domestic investment. Canada's decision to eschew major restrictions on capital account transactions was unusual in the Bretton Woods period. Indeed, the consensus during this period, on which today's international architecture is based, was that the dynamics of international capital markets sometimes contributed to domestic and external monetary instability. Exchange rate instability, viewed as inhibiting growth in international trade, was particularly problematic. The policy choice explicit in the Bretton Woods architecture was to create the conditions for an expansion of world trade and related payments by reducing movements in exchange rates, in an environment of limited capital mobility.

With the benefit of hindsight, a contemporary observer might interpret the policy choices in this period as part of the "impossible trinity" of international finance. Any country can maintain at most two of the following three policies: an open capital account, an independent monetary policy, and a fixed exchange rate. A key rationale for the Bretton Woods system was to permit countries to maintain fixed exchange rates, to permit the orderly expansion of trade. The capital controls in place in many countries allowed them to maintain fixed exchange rates without sacrificing their ability to pursue a monetary policy geared to domestic stabilization.

Canada's policy choices in much of the Bretton Woods period implied a different set of preferences, as the country operated a flexible exchange rate arrangement from 1950–62 in the context of an open capital account and an autonomous monetary policy. This mix of policies was a response to some circumstances of the Canadian economy. First, Canada's decision to maintain flexible exchange rates through most of the postwar period reflects in part the continued importance of commodity exports—and a recognition of the role of flexible rates in helping to provide a cushion against the terms of trade shocks associated with commodity price movements.

Second, Canada's long and generally uninterrupted history of integration with global capital markets, especially during times in which capital controls were commonplace in many industrial countries, illustrates the authorities' recognition that access to foreign capital contributes to investment and growth. Not only have open capital markets provided foreign savings to finance domestic investment, but they also promoted access to external business and financial expertise and other benefits. It is also well known, however, that international financial market integration can pose serious risks to macroeconomic stability if domestic financial markets are underdeveloped and domestic financial institutions are poorly managed, capitalized, regulated, and supervised.

The long history of stability of Canada's financial sector, in an environment of open capital markets, reflects in large measure the strength of Canada's financial sector policies, both regarding the regulation and supervision of financial institutions and the efforts to develop sophisticated domestic capital markets. Just as access to foreign capital is important to augment the supply of available resources for investment, deep domestic capital markets are necessary to provide appropriate options for domestic borrowers to fund themselves in local currency and at longer maturities. Canada has had a well-established bond market for many decades. But, a money market—essential for meeting the demand for short-term domestic-currency-denominated funds, for the effective operation of monetary policy, and for the prudent management of the public debt—was virtually nonexistent until the 1950s.

Market-opening reforms

Liberalizing controls on domestic markets for goods, services, and capital

Despite steady progress through multilateral trade liberalization in the decades following World War II, the manufacturing sector (with the exception of such areas as the auto industry, which through a special arrangement was already highly integrated with the U.S. market) entered the 1980s still exhibiting inefficiencies associated with short production runs and slow uptake of new technology and innovation. Indeed, by the late 1980s, it was recognized that inefficient domestic production—resulting in part from still inadequate openness to international trade in certain key sectors, despite several rounds of multilateral trade liberalization, together with the possible loss of access to the U.S. market—was posing a threat to the standards of living of Canadians and to the country's capacity to sustain high levels of social protection.

It was in this environment that the government began to pursue a vigorous agenda of bilateral and multilateral trade liberalization, beginning in 1989 with a Free Trade Agreement (FTA) with the United States. This agreement was expanded in 1994 to include Mexico under the North American Free Trade Agreement (NAFTA). Bilateral negotiations with other countries have also been concluded or are being pursued. Multilateral trade liberalization initiatives include a new round of WTO negotiations and the creation of a Free Trade Area of the Americas (FTAA).

Parallel to trade liberalization efforts, the environment for foreign direct investment (FDI) was also significantly liberalized. Investment has played an important role in linking Canada to the world economy, where the growth of global FDI exceeds that of global trade or production. Historically, Canada has relied significantly on foreign investment for its economic development. Today the stock of FDI in Canada represents approximately 26 percent of GDP, up from 18.5 percent in 1985. The performance of foreign-owned firms has been a key factor sustaining economic growth, generating substantial research and development activities, productivity gains, and a strong export orientation.

A significant shift towards a more open attitude on FDI occurred in 1985 with the passage of the Investment Canada Act (ICA). Most important, the ICA allowed notification to replace reviews for nonresident investment or acquisitions of Canadian businesses with assets less than $5 million. FDI policy was further liberalized with the Canada–U.S. FTA, NAFTA, and the GATS. In 1992 certain restrictions were removed on foreign ownership in the oil and gas sector.

Domestic economic policy reforms

Stability-oriented monetary policy

Like many other industrial countries, Canada experienced high inflation through the 1970s, with a second less intense, but still pronounced inflationary episode at the end of the 1980s. A protracted period of tight monetary policy—leading to recession and substantial excess capacity and high unemployment—was required in both instances to reduce inflation and break entrenched inflation expectations. By the early 1990s inflation and inflation expectations had been "ratcheted down" to the lowest levels seen in a generation. To consolidate this performance and to provide an anchor for monetary policy and inflation expectations, the government and the bank of Canada announced targets for inflation control in 1991. These targets, renewed on several occasions, have provided a solid and credible basis for monetary policy in Canada.

Achieving sound public finances

Addressing the fiscal situation faced by Canada in the early-1990s proved more difficult. Since the mid-1970s, fiscal deficits at all levels of government had been on the rise. This trend was not effectively stemmed by tax increases and expenditure restraint efforts in the 1980s. Furthermore, the high interest rates required at the end of the 1980s to contain inflationary pressures and the subsequent deep recession of 1990–91 caused fiscal balances to deteriorate sharply. By 1992 the total government deficit (federal, provincial, local, Canada Pension Plan, and Quebec Pension Plan) peaked at 9.1 percent of GDP.

Despite a gradual recovery from the recession, the government was by the mid-1990s faced with a still very difficult fiscal situation, one that caused some to speak of a "vicious circle". High real interest rates resulting from strong government demand for savings, together with risk premia as investors became concerned about future debt service capacity, dampened economic growth and led to a further deterioration in the public finances. Addressing the weakness in the public finances would thus have been a pre-eminent policy priority regardless of the degree of Canada's integration with international markets. The need to ensure that Canada was well-placed to meet the challenges of a more demanding international environment made deficit reduction particularly compelling.

Beginning in earnest with the 1995 budget, the government made important efforts to achieve fiscal sustainability, accompanied by similar actions at the provincial level of government. As a result, the balance of the total government sector improved rapidly, moving from a peak deficit of 9.1 percent of GDP in 1992 to a small surplus by 1997. Since that time, governments have continued to pursue fiscal discipline, achieving surpluses and reducing the debt burden. In 2001 the total government sector recorded a surplus of 2.4 percent of GDP, while the net debt was reduced to 43.6 percent of GDP[1], below the G-7 average and down 24.4 percentage points from its peak in 1995.

It is well accepted that strong, sustainable public finances are critical to the economic well-being of countries at all levels of development. Sound public finances engender confidence in the ability of a government to continue to provide essential public goods, including both macroeconomic stability and key social programs. Fiscal sustainability is even more important for countries whose financial markets are internationally integrated. By providing investors with external investment options, they create an environment less tolerant of inappropriate policies.

In Canada's case, the forces of globalization also had a substantial influence on the methods used to achieve successful deficit reduction. The fiscal improvement was accomplished almost entirely through reductions in program spending. This reflected the view that Canadian tax levels had already become sufficiently elevated, particularly in comparison with those in the United States, and that further increases would harm Canada's competitiveness and ability to attract and retain investment.

And unlike the general (and unsuccessful) expenditure restraint in the 1980s, the deficit reduction seen in the 1990s resulted from a thorough review of all program spending. The review did not focus exclusively on achieving cost savings. It also aimed to ensure that government programs supported an efficient Canadian economy capable of meeting the competitive challenges of an increasingly demanding global marketplace.

Structural policies to improve efficiency and competitiveness

Canada's pursuit of trade liberalization as the centerpiece of its market-opening strategy reflected the view that the competitive discipline from openness to international markets is essential to achieving the government's ultimate objective of sustained and equitable gains in standards of living. Yet the government's approach also recognized that openness must be complemented by broad-based efforts to improve the economy's internal efficiency and productivity—and thus its capacity to compete on international markets. Particular efforts were undertaken in four main areas.

First, Canada revised its regulatory framework in key areas, including transportation, the financial sector, and telecommunications. The overall aim of these reforms was to enhance competition and efficiency in these important sectors, and to ensure that remaining regulations were truly effective in achieving public policy priorities, including strong sustained growth. The second half of the 1980s and early 1990s saw significant changes as the government made regulatory reform a major policy priority. It deregulated the transport, energy, and telecommunications sectors to make them more responsive to market forces. More recently, it undertook major reforms in the financial sector, culminating in June 2001 with legislation to promote the efficiency and growth of financial institutions, foster domestic competition, and better protect consumers. Canada also updated key elements of its framework legislation, particularly the Competition Act and the Patent Act.

Second, beginning in the 1980s, the government reviewed its ownership of public enterprises, leading to privatizations in areas where government ownership was no longer necessary to achieving public policy objectives, where it compromised the sector's efficiency and competitiveness, or where it was necessary to enhance the effectiveness of improvements to the regulatory environment. These privatizations were especially significant in the transportation sector. These included the sale of Air Canada in 1988, Canadian National Railways in 1995, and Canada's air navigation system in 1996. In telecommunications, new legislation in 1993 aimed to increase reliance on market forces for the provision of telecommunications services. To date this has largely focused on increased competition in the market for long-distance service, however steps are underway to increase competition in the provision of local telephone service as well.

Third, the government significantly reoriented its role in economic development spending. Although driven in part by fiscal exigencies, it also reflected the recognition that many programs in this area had not achieved their objectives and that Canada continued to lag in R&D and productivity growth. This was worrisome in the era of the new economy, with growth increasingly driven by innovation. As a result of this reorientation, and to make programs more efficient, the focus of economic development shifted from government-directed assistance to joint public-private initiatives—and from direct grants to repayable contributions and tax measures.

The government has committed to working with Canadian industry, the provinces, communities and the public on private sector solutions to further broadband Internet coverage in Canada, particularly in rural and remote areas. To that end the 2001 budget announced funding of $105 million over three years to support broadband Internet expansion. In September 2002 the government announced the Broadband for Rural and Northern Development Pilot Program, with two parts. The first provides funding in support of the development of detailed business plans identifying demand and sustainability of broadband infrastructure. The second provides funding for the implementation of the business plan.

Fourth, Canada moved to put in place a more competitive tax regime, in response to a growing consensus that the FTA with the United States highlighted the need to address certain tax-related obstacles to trade. One such obstacle was the federal manufacturers sales tax that made Canadian exports less competitive and favored imports over domestically produced goods. This tax was replaced in 1991 with a value-added tax. Also important in this respect was the decision, announced in the 2000 budget, to begin a phased reduction in federal corporate and personal taxes over the next several years. This decision, made possible by the dramatic improvement in the fiscal situation, reflected the recognition that tax structures are critically important in retaining highly skilled labor, and the need to enhance Canada's attractiveness as a location for new investment.

Social protection and human capital investment

Canadians have long put a high priority on public policy measures to protect the less fortunate from adverse economic and social outcomes, and help achieve meaningful equality of opportunity. This consensus is deeply grounded in Canadian values. Yet many of Canada's social programs also represent a pragmatic economic policy response aimed at improving aggregate social welfare in an environment of risk and uncertainty. These uncertainties are particularly important for Canada, a small open economy, typically a price taker on world markets—historically oriented toward production of natural resource commodities whose prices are often volatile, leading to swings in employment and income across different sectors and regions.

From this perspective, social programs in Canada provide insurance against risks that are privately uninsurable, either because the magnitude of the necessary transfers would exceed the resources available to any private insurer—or because market failures, such as moral hazard or adverse selection, militate against effective private insurance against these risks. Programs in this category include those that involve direct income transfers, such as employment insurance and public welfare, as well as the public health care system. Canada's social programs also serve an important redistributive function. Although the primary rationale for this rests in the value placed by Canadians on social equity, it can also be seen as a means of improving economic welfare, by redistributing rents earned in such sectors as natural resource extraction.

Canada's social programs have become more important amid the uncertainty associated with the rapid changes in technology, competitive forces, and patterns of demand associated with globalization. In the 1990s it became clear that these programs must change, to ensure their fiscal sustainability and, more important, to ensure that they protect Canadians while giving them the tools and incentives to prosper. To help achieve these objectives, the government undertook reforms aimed at better targeting social assistance programs, ensuring their fiscal sustainability, and providing Canada's provinces with greater flexibility in allocating federal funds in line with their own priorities.

Among the most important of the changes were those to Canada's employment insurance program. In 1996 this program was reformed by reducing expenditures on income support and increasing spending on measures to help the unemployed find and keep employment. Changes to the income support element of the program included reductions to the benefit rate and the number of weeks of benefits available, as well as a slight increase in the length of employment required to qualify for benefits. At the same time, additional funds were provided for training courses, costs of self-employment and mobility, and re-employment incentives.

Efforts were also made to ensure the long-term sustainability of some programs. One example was the Canada Pension Plan, an earnings-related plan financed by employer and employee contributions, reformed to avoid unsustainable increases in the contribution rate that would otherwise be needed as the large baby-boom generation retires. Instead, immediate and moderate increases in the contribution rate were made, and a new policy was adopted allowing funds to be invested in financial markets. This will result in the build-up of a large reserve fund to help finance future pensions.

Although many of the changes to Canada's social programs were driven by the need to restore fiscal sustainability, this period also provided an opportunity to improve their effectiveness. Even at the peak of the restraint efforts, the federal government did not stop reinvesting in human capital development, and this accelerated sharply once the deficit was eliminated. In some cases, programs were more carefully targeted to those who need them. Particular measures were targeted toward improving the health care system and helping vulnerable groups such as urban aboriginals, youth at risk, and children from low-income families. The government has also put spending priority on initiatives to help Canadians adapt to the demands of the knowledge-based "new economy". For example, the Canada Foundation for Innovation was created to modernize Canada's research institutions in key areas. In addition, the government introduced the Canadian Opportunities Strategy to help Canadians finance education and acquire the knowledge and skills to participate in, and benefit from, opportunities in a knowledge-based economy.

The overall result of these reforms is that Canada's social programs became more efficient and effective. Incentives to labor market participation have been enhanced. Innovation has been fostered. And access to knowledge and skills at all stages of life has been improved.

Canada's policy response to globalization

Since the mid-1980s Canada has embarked on policy initiatives to create a macroeconomic and structural environment conducive to greater productive capacity while better enabling firms and workers to respond to the challenges associated with new technologies and a fast-paced global market. Some of these efforts were in traditional areas of economic policy. Others were in areas traditionally regarded as social policies, but which had come to be viewed as crucial in combining improved economic performance with the continued high levels of social protection valued by Canadians.

These policies included decisive measures to address Canada's fiscal problem, which had threatened to create a cycle of higher interest rates, higher deficits, and deteriorating economic performance. They also included efforts toward trade liberalization, most notably the FTA with the United States, aimed at enhancing market opportunities and attracting new investment. Trade liberalization was complemented by a range of internal structural measures, such as privatizing key public enterprises, reorienting government business programs, reducing internal barriers to trade, reforming tax policy, and improving the regulatory framework governing key areas of the economy, such as transportation, finance, and telecommunications.

The benefits

By expanding the scope for competition, innovation, and efficiency, the reforms to fiscal, monetary, and trade and investment policies, and to internal structural policies generated positive spillovers in other sectors of the economy, and have contributed to making Canada much more competitive, open, and prosperous. Through the FTA and NAFTA, trade as a proportion of GDP has grown rapidly, from about 25 percent in 1989 to some 40 percent by 1999.

Most important, the Canadian economy has performed strongly overall. Over the past four years Canadian real GDP growth averaged 4.4 percent, the strongest in the G-7. Employment growth has also led the G-7 economies, resulting in a decline in unemployment to a 26-year low of 6.8 percent in 2000. Despite this strong growth performance, underlying inflation has remained low and stable as costs were held back by a doubling in labor productivity growth in the last four years relative to the previous two decades. This is due to strong business investment and total factor productivity gains. The above developments have helped to push the average growth of real disposable income per capita up to 2.8 percent per year, above that of the United States since the end of 1997.

The external current account balance also moved from a record deficit in 1993 to a record surplus in 2000, reducing Canada's foreign indebtedness relative to GDP to its lowest level since the 1950s. This, and the substantial progress in reducing the public debt burden, has given the federal government more flexibility to address domestic economic priorities—and the central bank more room to lower interest rates in the recent global slowdown.

Just as important as the effect of these reforms on measurable GDP growth is the positive impact on the less-easily measured, but equally important variables of economic welfare.

Canada's success in achieving low inflation and sound public finances has created a climate of greater certainty in which individuals and firms alike can make decisions with confidence. Market-opening measures and complementary structural reforms—including deregulation in key sectors and changes to competition policy—have expanded consumer choice and contributed to lower prices and higher real incomes. The continuing priority attached to Canada's social programs has supported the investment in human capital essential to economic growth. These social programs equip Canadians with the tools to prosper in the global economy while protecting them from its vicissitudes.

In assessing these reforms, it is easy to overstate the extent to which the policy initiatives in key areas—such as deficit reduction, monetary policy, and trade and structural reforms—were a conscious and meticulously planned response to the challenges of globalization. Instead, it would be more correct to regard them as motivated primarily by the general objective of improving the efficiency of the Canadian economy and raising the standard of living and economic security of Canadians.

Little in the Canadian experience suggests that globalization has fundamentally changed ideas of what constitutes "best policy". Indeed, the most important of the domestic policy initiatives would have been highly desirable for increasing competitiveness and efficiency, while promoting equity and social protection, in an economy for which openness to the global economy was not a realistic prospect. It is therefore more accurate to assess the Canadian experience as one in which the more demanding external environment resulting from globalization increased the importance of policy reforms that would have been essential in any case to ensure the strongest possible sustained growth in living standards.

Challenges and uncertainties

While it is clear that the policy reforms in Canada since the mid-1980s resulted in a more open and dynamic Canadian economy, their impact must be tempered by the recognition that the reform process was incremental and sometimes ad hoc. A key question relates to what changes to the sequencing and pace of these reforms would have been appropriate in order to maximize their benefits. Although specific conclusions are difficult to draw, it is certain that there was room for improving on the general approach that Canada followed.

In the late 1980s, it would have been impossible to accurately forecast the breadth and depth of global economic change, particularly the rapidly emerging knowledge-based economy. Since the reforms were not part of a cohesive plan to adjust to globalization, but often a response to fiscal imperatives or domestic industry pressures, the lag between reforms may have limited their impact, a view supported by the OECD in its 1999–2000 annual review of Canada (OECD 2000). According to some analysts, if tax reforms had been implemented at the same time as macroeconomic reforms, greater benefits would have been realized (Martin and Porter 2001). Similarly, if a more comprehensive series of labor market reforms had been undertaken earlier, overall economic performance would likely have been enhanced, and the costs of reducing inflation in the early 1990s might have been reduced.

Some factors that influenced the pace, sequencing, and impact of the reforms in Canada cannot be automatically transported to all other countries. For example, the nature of Canada as a federal state, with distinct region economies, clearly influenced what was feasible in some areas. Further, Canada's location next to the United States and its huge volume of trade with that country strongly influenced its policy decisions. Policy in certain areas was often driven by the need to compete with the United States as an exporter and as an investment location. Policy in other areas less directly affected by proximity to the United States did not receive the same impetus.

Perhaps inevitably, given the absence of a comprehensive plan for these reforms at their outset, reforms have sometimes had unintended consequences, both positive and negative. Indeed, some outcomes are puzzling even in retrospect. For example, the increase in both exports and imports following the implementation of the FTA and NAFTA was larger than expected—perhaps evidence that the welfare impacts of these trade liberalization measures were also larger than expected. But this strong trade performance was not matched by unambiguous evidence that Canada has launched itself on a permanently higher productivity trajectory, either in absolute terms or in comparison with the United States.

International institutions and a strong policy consensus

Canada's macroeconomic and structural policy responses have been greatly facilitated by its membership and active participation in such international organizations as the IMF, the OECD, and the WTO.

The annual consultations with the IMF and OECD have been useful forums for discussing policy options in both macroeconomic and structural areas and examining them in an international context. The discussions have provided the opportunity to examine other countries' policy responses to similar challenges and draw lessons from their experience. In particular, Canada's policy agenda over the past 10 years has been strongly supported and reinforced by the IMF and the OECD. For example, in the early 1990s, the IMF consistently and strongly advocated a comprehensive fiscal consolidation program for Canada. Consistent with the government's policy agenda, this helped foster public support for implementation. Since the elimination of the federal budget deficit in 1997–98, five consecutive years of budget surplus have given the government the flexibility to increase its investment in key areas, cut taxes, and pay down the debt. Both the IMF and the OECD have been very supportive of the government's decision to use part of the budget surplus to pay down the debt. This, together with strong economic growth, has resulted in a significant reduction in Canada's debt-to-GDP ratio over the past five years.

Canada's membership in the GATT/WTO has been one of the primary mechanisms supporting trade liberalization. Through several rounds of negotiations in the postwar period, Canada has progressively negotiated reciprocal trade concessions with other GATT/WTO members. Initial rounds focused on tariff reductions, but soon moved into other trade-related areas such as standards, investment, government procurement, and trade remedies. This system was effective because trade concessions could be marketed more effectively domestically if the benefits of reciprocal trade concessions by key trading partners could also be seen. Moreover, once tariff concessions were granted, they could not be reversed. The Dispute Settlement Mechanism has provided further incentive to ensure that policies are consistent with WTO rules. Under this system, members may challenge the trade-distorting policies of others—and may be granted the right to retaliate if other members fail to comply with WTO rules.

Canada's trade policies are reviewed every two years through the Trade Policy Review Mechanism of the WTO, other WTO members identify areas where further trade liberalization is possible. This provides an external rationale for trade policy liberalization, which can help in garnering domestic support. Some problem areas identified so far include tariff peaks in textiles and clothing, high tariffs and supply management programs in agriculture, the lack of consistency in standards and government procurement practices across the provinces, and regulatory barriers in telecommunications, transportation, and finance.

Notes

1. Excluding government employee pension liabilities, in order to be comparable with other countries' debt measures.

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China

China's financial sector reform has resulted in significant institutional improvement and sustained strong economic growth performance. Between 1978 and 2000 its real GDP grew at an annual rate of 9.6 percent, and per capita GDP at 8.2 percent. Total trade (imports plus exports) rose from $21 billion a year to $474 billion, annual growth of 9.4 percent. Foreign exchange reserves jumped from just $840 million to $166 billion. Meanwhile, foreign direct investment grew from zero to a cumulative $350 billion.

It was in 1978 that the first steps were taken to reform and open China's financial sector. Since then China has pursued an innovative reform path crafted to meet its distinctive economic and social conditions. A network of financial intermediaries and market mechanisms suited to the emergence of a market economy has been established, underpinned by a legal framework and official supervisory system.

China will continue to draw on the experiences of developed countries and other developing countries to achieve a sound, comprehensive, and effective financial system.

Financial reform over the past 20 years

Five key reform elements can be distinguished. First, a central banking system has been developed and refined structurally, for more effective monetary policy and greater macroeconomic stability. Second, a diverse network of financial intermediaries has been established. Third, financial markets have been developed. Fourth, an effective system of financial regulation and supervision has been put in place. Fifth, the financial sector has—gradually and cautiously—been opening up to the outside world.

Establishing and improving the central banking system

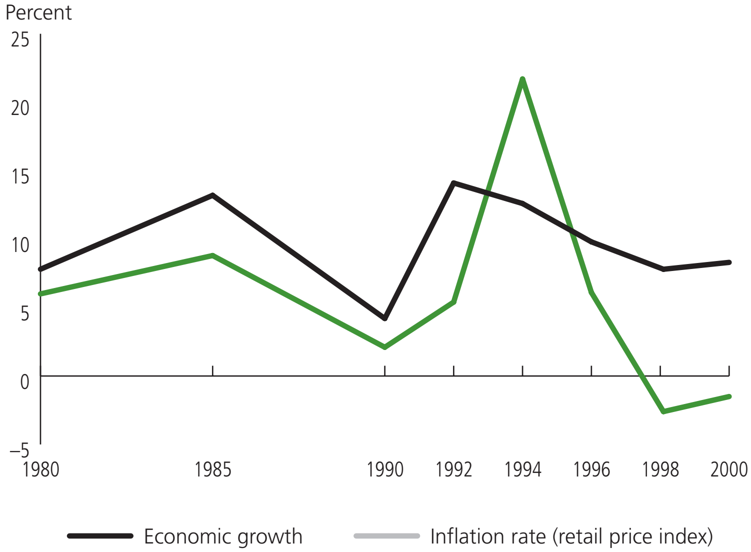
Since 1978 the People's Bank of China (PBC) has undergone four major reforms. The first dates to 1978, when it became independent of the Ministry of Finance, transforming it from an arm of the ministry to a stand-alone bank, exercising functions proper for a central bank and undertaking commercial banking business. This reform put an end to the old situation where public finance dominated banking, and, in particular, introduced for the first time a real distinction between budgetary issues and finance.

The second reform began in 1984, when the PBC was specifically designated as the central bank of China, no longer allowed to do commercial business. This took away the dual mandate of financial authority and commercial bank and established the PBC unambiguously as a monetary authority. The third reform, in 1995, promulgated the Law of the People's Bank of China, legally establishing the status and functions of the PBC as those of a central bank. Then there was the fourth reform in 1998, a breakthrough in the organizational and management structure of the PBC. The old branch structure, with 32 provincial branches organized along administrative lines, was consolidated into a nine-branch structure, with each branch covering an economic region. This change strengthened the independence of the central bank in implementing monetary policy as well as financial supervision and regulation.

Better conduct of monetary policy

Monetary policy instruments in China have been gradually refined with the transformation of the economic system, the development of

Figure 1. Macroeconomic performance



financial institutions, and the maturation of the market. Until the early 1990s, China relied mainly on such direct means as quantitative credit control to influence the evolution of the money stock. A major overhaul of the system of monetary control was introduced in the latter half of 1992 at a time of overheating, with accelerating consumer price inflation (figure 1) and exchange rate fluctuation. Identifying as the key objective a tightening of monetary policy (bringing monetary growth to a level just below the growth of nominal GDP), a combination of policy instruments was brought into play for reserve requirements, central bank lending rates, and open market operations. Instead of controlling the quantity of credit, the authorities began to employ the monetary aggregate as their operating target.

Since 1998 there have been further reforms in the mechanism of monetary control. The PBC has abolished credit quotas for state-owned commercial banks, completing the transition from direct to indirect control of the total supply of money and credit. The reserve requirement system has also been reformed, integrating the excess reserve accounts with the required reserve accounts and restoring the payment and clearance functions of the reserve accounts. Commercial banks are now allowed to provide consumer credit where conditions permit. Efforts have been enhanced to use the open market operations, increase the variety of financial products for transaction, and promote market-based flotation of financial policy bonds. The permissible range of commercial bank lending rates has been widened.

Establishment of diversified financial institutions

The first task in building a diversified network of financial institutions was to establish a state-owned commercial banking system. China began to set up state-owned commercial banks in the late 1970s. The Agricultural Bank of China specialized in rural credit, the Construction Bank of China in fixed asset investment, and the Bank of China mainly in the foreign exchange business, all reinstituted in 1979. In 1984, with the refocusing of the PBC as central bank, the Industrial and Commercial Bank of China was set up to serve a target client base industrial and commercial enterprises.

Next, the operations of the state-owned commercial banks were strengthened, beginning in the latter half of the 1980s. To satisfy the needs of enterprises for diversified financing, the sectoral barriers among the commercial banks were removed. In 1994 three banks were formed to undertake the policy financing previously assigned to the specialized banks: fixed asset investment, agricultural procurement, and international trade. The former specialized banks became commercial banks in the sense that, even though wholly state-owned, they engaged in commercial financial business only. To ensure that they really would be commercial banks, reforms were carried out to strengthen the management of each state-owned commercial bank on a consolidated legal person basis, delink them from their nonbanking arms, and improve internal management and risk-control mechanisms.

The Commercial Banking Law of the People's Republic of China was promulgated in 1995 to provide a legal framework for standardizing the operations of the commercial banks. In 1999 four financial asset management corporations were set up, taking over 1.3 trillion yuan of nonperforming assets from the four state-owned commercial banks. The government has also taken various measures to increase the capital adequacy of the state-owned commercial banks.

These reforms have expanded the scope of business of the state-owned commercial banks, separated policy and commercial business, strengthened internal management and risk prevention, and improved competitiveness.

China has not neglected the development of a variety of other financial institutions. Since 1984 other banks with different ownership structures have been set up, as well as various nonbanking financial institutions, such as securities, insurance, trust, and finance companies. So, even though the state-owned commercial banks still play a dominant role, many other financial institutions are active in the market. By the end of 2000, apart from the three policy banks and the four wholly state-owned commercial banks, there were 10 share-holding commercial banks, 99 city commercial banks, 1,695 urban credit cooperatives, 39,255 rural credit cooperatives, 71 enterprise group finance companies, 12 financial leasing companies, nearly 100 trust and investment companies, 100 securities firms, 13 insurance companies, and 191 operational foreign-funded financial institutions.

The reform of the financial system helped increase the strength of the financial sector. By the end of 2000, total assets of the financial industry reached 19.7 trillion yuan, more than twice the GDP of that year, and a 65-fold increase over the two decades. Assets of the wholly state-owned commercial banks alone came to 124 percent of GDP; assets of the policy banks, 17 percent; share-holding commercial banks, 16 percent; city commercial banks, 6 percent; urban credit cooperatives, 1.6 percent; and rural credit cooperatives, 17 percent. Total deposits in the financial institutions reached 12.4 trillion yuan, 138 percent of GDP. Aggregate loans topped 9.9 trillion yuan, also exceeding GDP. Interestingly, associated with this rapid financial deepening, bank lending began to assume a major role in the financing of national fixed asset investment. In 2000 lending by wholly state-owned banks financed 41 percent of fixed asset investment in China, up from 7 percent in 1980.

The insurance sector, though much smaller, has also grown. The total assets of insurance companies reached 337 billion yuan in 2000, 4 percent of GDP, with premium income of 160 billion yuan, 2 percent of GDP.

The reform of the financial system also improved the quality of financial services. Previously all that was available was elementary banking, based on deposits and loans. Now many other financial services are widely used, including securities, insurance, trust and investment, leasing, and investment. Such lines as international settlement, exchange, real estate, consumer credit, and banking cards are developing, and such intermediate business as company financing, finance consultancy, commissioned transactions, fee collection, and salary accounts are rapidly expanding.

Establishment of a comprehensive financial market system

A money market had already emerged in China by the early 1980s. Since then, it has been developing rapidly, with a variety of instruments (table 1). Apart from interbank lending, it is also possible to trade in financial products such as negotiable bills and short-term government bonds (repurchase of government securities). The volume of trade has also been increasing rapidly. In 2000 transactions on China's money market exceeded 3 trillion yuan, 35 percent of the GDP that year and a 10-fold increase over the late 1980s. The functioning of the money market has also improved, providing a venue for the commercial banks to get short-term liquidity and creating conditions for the open market operations of the central bank.

TABLE 1
China's money market, 1986–2000
(billion yuan)

Year	Interbank lending	Repurchases	Negotiable bills	Commercial banks discounts	PBC discounts
1986	30.0		0		
1987	230.0		0		
1988	524.0	0	0		
1989	293.4	0	0		
1990	264.1	0	0		
1991	292.7	0	0		
1992	450.0	0	0		
1993	250.0	0	0		
1994	n.a.	0	0		
1995	820.2	0	242.4	141.2	84.4
1996	587.1	0	389.0	226.5	135.0
1997	414.9	30.7	460.0	274.0	133.2
1998	98.9	102.1	384.1	265.0	120.0
1999	323.9	395.7	507.6	249.9	115.0
2000	672.8	813.3	744.5	644.7	266.7

Since the opening of Shanghai and Shenzhen stock exchanges in December 1990, great progress has been made in developing China's capital market (figure 2). The issuance volume of government securities, corporate shares, and bonds has greatly increased. Enterprises have become more dependent on direct financing. And the overall financing structure of firms and the asset structures of individuals' portfolios have undergone profound changes. The capital market is doing more in resource allocation, and its efficiency has been constantly improving. At the end of 2000, 1,121 companies were listed at home and abroad, with a total market value of 4.8 trillion yuan, roughly 57 percent of the GDP. About 50 million Chinese invest in stocks.

Establishment of an effective financial supervision framework

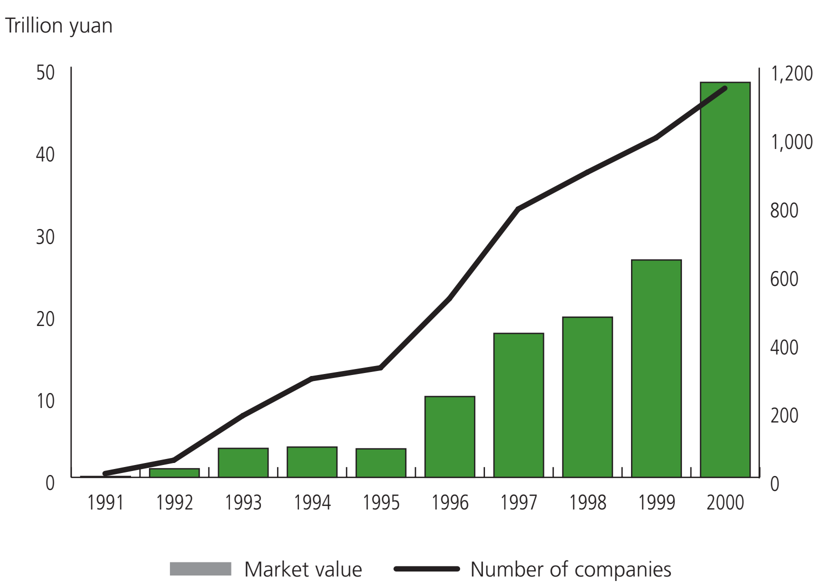
In 1998 China reformed the organizational structure of financial supervision and regulation by establishing securities and insurance regulatory authorities separate from the PBC.

The PBC, as the regulatory authority and supervisor of the banking industry, has done much to strengthen financial supervision and regulation since 1993. It has increased supervisory departments, defined the functions of banks, nonbanking financial institutions, and insurance and auditing firms, and clarified responsibilities for financial supervision. The division of labor between the PBC headquarters and branches in financial supervision has been redefined, and the focus of the branches has been shifted from credit allocation to financial supervision. With the overarching goal of monitoring risk, financial supervision has evolved from general verification of administrative procedures and financial management into a comprehensive supervision covering market access, business operation, risk monitoring and control, and market exit. Effective measures have been taken to contain risk for financial institutions with excessive risk exposures, explore approaches for market exit, and improve the capacity to handle financial risks.

The China Securities Regulatory Commission, as the supervising authority of the securities industry, has improved its regulatory framework by setting up and maintaining direct control over its local offices in major cities. It has researched and formulated policies and plans as well as the necessary laws and regulations for the development of the securities and futures markets. It has also investigated the securities companies, taken needed corrective actions, and formulated and implemented schemes aimed at preventing and warding off risks confronting securities companies. The commission has also been suppressing illegal over-the-counter stock exchanges. Problems with the provincial securities exchange centers have also been dealt with. The futures market has been standardized, with some futures exchanges reorganized into securities brokers and dealers. The implementation of these reform measures has greatly enhanced the supervision over the securities market and made its operations more standard.

The China Insurance Regulatory Commission, since its establishment in 1998, has worked out policies, laws and regulations, development strategies, and plans to develop the insurance industry and cultivate the insurance market. It has carried out supervision, regulation, and business guidance over the operations of the insurance sector. This has included investigating and sanctioning firms in violation of laws or regulations, protecting the interests of the insured, taking precautions against and reducing risks in the insurance industry, and safeguarding the stability of the insurance market.

Figure 2. Stock market development



Steadily opening the financial sector

Vigorous encouragement of entry by foreign-funded banks

In line with the overall goal of opening up the Chinese economy, there has also been a measured policy of financial opening, with the entry of foreign-funded financial institutions encouraged by lifting the geographical restrictions on establishing foreign financial institutions. At the beginning, foreign financial institutions were allowed only to come to the special economic zones and selected coastal cities. Gradually this was extended to all major cities. The scope of business opened to foreign financial institutions has also been gradually expanded from foreign currency business only to being partially allowed to conduct yuan business.

At the end of 2000, 87 foreign financial institutions and enterprise groups from 22 countries and regions maintained 191 operational financial establishments in China, including 7 joint venture banks, 6 wholly foreign-owned banks, 7 finance companies, and 158 bank branches. Thirty-three foreign banks have been permitted to conduct yuan business. Apart from that, 166 foreign banks from 38 countries and regions have set up 248 representative offices in China. The total assets of foreign financial institutions in China have greatly increased, reaching $34.4 billion by the end of 2000, with a total loan balance of $18.6 billion. The resources of the foreign banks come mainly from their headquarters abroad, which provide about 70 percent of total funds.

Sound Chinese financial institutions have been actively encouraged to explore overseas business. Chinese banks and insurance companies have set up branches in 24 countries and regions on five continents, with an aggregate employment of 30,000.

Introduction of a unified exchange rate and current account convertibility

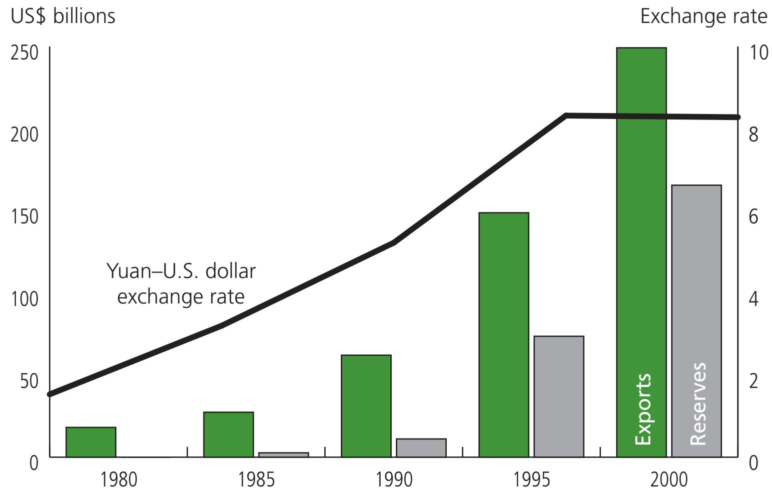
From the beginning there has been a gradual relaxation of exchange controls. In 1979 a method of foreign exchange earning retention was introduced. The following year a foreign currency swap center was established, and a dual exchange rate system introduced, distinguishing between the price for trade-related foreign exchange purchase and the official public exchange rate. In March 1988 the restrictions on the exchange rate at the swap center were lifted, allowing it to float within a certain range of the official rate.

1994 saw a major reform of foreign exchange administration and exchange rate regime. A single managed floating exchange rate was introduced on the basis of market supply and demand. An interbank foreign exchange market was set up with the establishment of the China Foreign Exchange Trading Center in Shanghai on April 1, 1994, for the surrender and purchase of foreign exchange related to current account transactions.

In 1996 China further relaxed foreign exchange control. Since then, the foreign exchange surrender and purchase system has become applicable also to foreign-funded enterprises and restrictions on their use of foreign exchange under current account were removed. Foreign banks in China and Chinese-foreign joint venture banks have been allowed to handle the foreign exchange surrender, purchase, and payment business of foreign-funded enterprises. Individuals have since been allowed to exchange more foreign currency for personal needs. Restrictions over the nontrade, nonregular use of foreign exchange for cross-border exhibitions and investment promotion have also been removed. Foreign organizations and individuals in China have been allowed to remit their lawful income out of China. With the implementation of these measures, China met the requirement of Article VIII of the Articles of Agreement of International Monetary Fund and announced current account convertibility of the yuan as of December 1, 1996.

Reform of the foreign exchange system has facilitated vigorous growth of international trade and foreign direct investment, resulting in big increase of China's foreign exchange reserves (figure 3). China's export volume increased from $18.1 billion in 1980 to $249.2 billion in 2000, a 14-fold increase. Between 1979 and 2000 Chinese and foreign businessmen signed 363,000 direct investment

Figure 3. Reserves, exports, exchange rate



contracts, with actual use of direct investment topping $350 billion. In 2000 foreign-funded enterprises in China exported $119.4 billion, 48 percent of total exports. Foreign-funded enterprises are now important in promoting the Chinese economy.

China's foreign exchange reserve has also expanded considerably, from $840 million at end-1980 to $165.6 billion at end-2000. The increased foreign exchange reserves have helped enhance China's overall national strength and its resilience to risks. In the face of the Asian financial crisis in 1997 and the accompanying drastic depreciation of Southeast Asian currencies, the Chinese government undertook to maintain a stable yuan exchange rate, which not only prevented the spread of the crisis into China but also stabilized Asian economies and finance.

Financial reform and economic restructuring—in parallel

Overall economic restructuring in China since 1978 has gone through three phases. The first was from 1978 to 1984, when the reform focused on the countryside with the household production responsibility system being introduced in the villages. Pilot programs were carried out in allowing enterprises greater autonomy. Also on a pilot basis, enterprises were shifted to a regime in which they paid taxes instead of handing over all profits to the government. In this early phase, 4 special economic zones and 14 coastal port cities were to open to the outside world.

The second phase was from 1984 to 1991, when the focus of reform was in the cities. Pilot schemes to reform state-owned enterprises were introduced and efforts made to encourage the development of private enterprises and township enterprises.

The third phase was from 1992 to 2000, when comprehensive reforms centering on the restructuring of the state-owned enterprises were carried out. Key elements included modern enterprise management systems, macroeconomic restructuring, reform of the foreign exchange and foreign trade systems, and housing and social security reform.

The tasks of the first two phases were to break up the old system, while the third aimed at establishing a new socialist market economy system.

China's financial reform can be seen, for the most part, as proceeding in parallel with the wider economic restructuring, reflected in the way the diversification of financial institutions mirrors the diversification of enterprise ownership. The development of the financial market, particularly the stock market, can be seen as analogous to the transformation of the operating methods of enterprises. Reform of the foreign exchange system went hand-in-hand with reform of the foreign trade and investment system, as did reform of state-owned commercial banks and state-owned nonfinancial enterprises.

Steadiness and gradualism in financial reform

There are two ways of making an economic transition: radically and gradually. Proceeding from its national conditions and realities, China chose the road of gradually transforming its economic system, "navigating across the river by fathoming the course through underwater stones". Reform began in the rural areas, where the planned economic system was relatively weak, and was rolled out to cities step-by-step. The price reforms were done by introducing more and more relaxed control into government regulation with a view to the final removal of price controls. Opening to the outside world was piloted in coastal areas first, and when sufficient experience had been gained, rolled out to the inland areas. Ownership reform was carried out by developing the non-state-owned sector while making adjustments in the state-owned sector. Reform of the state-owned enterprises began with allowing the enterprises more autonomy and increasing their retention of profits, and evolved into the establishment of modern enterprise management systems and readjustment of the behavior of the state-owned sector.

Financial reform has also been gradual. State-owned commercial banks were set up first, and then financial institutions with other ownership structures began to develop. Later, strengthening and reforming the other financial institutions was tackled before that of the state-owned commercial banks. The money market was established and deepened before the foreign exchange and capital markets were developed. Gradual relaxation of quantitative control of credit came ahead of open market operations, rediscounting, and other indirect ways of macrocontrol and regulation. Restrictions on money market interest rates were removed before the relaxation of control over government bond and bank lending interest rates.

The reform and opening of the financial system has been led by the government

The establishment of financial institutions and the formation of financial markets in China is quite different in one important respect from many western developed countries. Rather than evolve spontaneously, markets and institutions have emerged under the leadership of government, in response to its perception of the needs of economic development. For example, the establishment and reform of the state-owned commercial banks, the development and standardization of small and medium-sized financial institutions, the building up and development of the financial market have all been led and guided by the government. This has enabled Chinese financial institutions and financial markets to rapidly meet the need of economic reform and development.

With the growing role of the market in the Chinese economy, the government has shifted the emphasis in financial reform from administrative directives to legislation. Among the many laws and regulations promulgated since 1995 are the Central Bank Law, Commercial Banking Law, Securities Law, Insurance Law, Law on Negotiable Bills, and the Decision to Punish Crimes Undermining Financial Order.

Identifying monetary policy targets commensurate with national conditions is the key to maintaining macroeconomic stability

The monetary policy objective set for the PBC has also evolved over the years. The Regulations of the People's Republic of China on Bank Management, issued in 1986, set for monetary policy the dual goal of stabilizing the currency and developing the economy. At that time, with the reform of investment and financing not yet accomplished, the condition of industry was such that capacity constraints meant that the supply of many products fell short of demand. As a result, when the local governments urgently wanted to develop the local economies, the central bank was under enormous pressure to increase credit and money supply. In some years, the two goals of stabilizing the currency and developing the economy seriously conflicted, and when this happened the development goal usually prevailed over that of stabilizing the currency. So, although the economic growth rate remained high, inflation surged, especially in 1988 and 1993.

In 1993 the Decision on Matters Relating to the Establishment of a Socialist Market Economy made at the third plenary session of the 14th CPC Central Committee and the Decision on Reform of the Financial System of the State Council clearly redefined the objective of the Chinese monetary policy as maintaining a stable currency and promoting economic growth. In March 1995 the Law of the People's Republic of China on the People's Bank of China (Central Bank Law) was promulgated, designating that as the ultimate objective of China's monetary policy in explicit legal terms, correctly sorting out the relations between having a stable currency and promoting economic growth, and formally rejecting dual objectives for monetary policy. As a result, the Chinese economy entered a stage of high and steady growth and low inflation.

The opening of the financial market has been gradual

With the Chinese economy opening to the outside world, the financial sector was also opened gradually. In 1981 foreign financial institutions began to set up representative offices in China. In 1985 foreign financial institutions were allowed to open operational branches in the five special economic zones of Shenzhen, Zhuhai, Xiamen, Shantou, and Hainan. In 1990 Shanghai became the first coastal open city outside of the special economic zones to bring in operational foreign financial institutions. After that, another seven coastal cities, including Dalian, were also allowed to do so. In 1992 American International Assurance (part of the AIG group) set up its branch in Shanghai, marking the start of experimentation with opening the Chinese insurance market. In August 1994 Beijing and 10 other inland cities were added to the list of localities open to operational foreign financial institutions. In December 1996 foreign financial institutions were allowed to conduct yuan business in Pudong, Shanghai, and the practice was later extended to Shenzhen.

The greatest advantages of gradual opening are that, since there is no need to accomplish everything at one go, there need not be too great a macroeconomic impact. Experience can be constantly assessed and the plan adapted appropriately to ensure that practice fits national conditions.

An important lesson the Chinese authorities drew from the Southeast Asian financial crisis is that in the process of financial liberalization, some countries had been overhasty in relaxing financial controls by interest rate liberalization, deregulation, premature opening of the capital market, and establishing offshore financial markets. Premature adoption of these measures contributed to the outbreak of the financial crisis. In contrast, drawing fully on the lessons of previous experience, the Chinese government strengthened its management of the capital account following introduction of current account convertibility, preventing the crisis from spreading to China.

Priorities and targets of the next-step financial reform and development in China

With China's entry into the World Trade Organization, its financial sector will face huge changes, manifest in the following areas. First, the system of supervision and regulation is not yet prepared for the complexities of the new situation. Second, the financial market is not so developed that it can be relied on to avoid any threat to macro instability and to ensure an optimal allocation of resources. Third, there is still a gap between the management and operational capacity of the wholly state-owned commercial banks and that of the world's leading banks. Fourth, there are still hidden problems in the rural financial system.

For these reasons, China must continue to deepen its financial reform, strengthening institutions and markets and improving the supervision, regulation, and control mechanisms of the financial sector. A sound monetary policy will continue to be needed, adjusting monetary conditions appropriately to facilitate economic restructuring and growth. Overall, the Chinese financial sector's capacity to deliver services will have to be improved to enhance the sector's competitiveness. Efforts will be made to prevent and dissolve financial risks and enhance the quality of bank assets. Comprehensive reforms will be carried out in wholly state-owned commercial banks, bringing them into line with best contemporary banking practice. The rural financial system will be reformed to redouble financial support for farmers and agricultural development. The strong balance of payments performance will be maintained. The managed floating exchange rate system based on market supply and demand will be further improved.

Improving the monetary policy system relying on indirect instruments

China will continue to pursue a sound monetary policy and seek refinements in the conduct of monetary policy, by relying mainly on indirect policy instruments. First, open market operations will be expanded, and the quality of the relevant decisionmaking will be improved to ensure that the timing and scale of open market transactions are optimized. Transaction frequency will be increased, and fine-tuning measures will be taken as the occasion warrants. While an increasing volume of repurchase transactions can be expected, there will also be more use of outright transactions. Flexibility will be exercised in selecting modes of transaction to give further play to the open market in guiding short-term interest rates on the market. The role of the primary dealers will also be given more scope in activating the market, transmitting monetary policy, and expanding the effects of open market operation. Market infrastructure will be strengthened through improvements in the settlement and clearing system.

Second, rediscount business will be further developed. While expanding the range of bills eligible for discount, the ceiling on discount interest rate will be gradually lifted in support of the market-based interest rate reform. The purpose is to enhance the role of rediscount in guiding market interest rate and commercial bank behavior.

Third, the required reserve system will be further improved. The basis for calculating the required reserves will be improved by introducing the concept of average balance in the accounting period. Verification of the required reserve will also be improved accordingly.

Fourth, efforts will be made to gradually increase market influence over the degree to which interest rates vary around the central bank rates, with money market interest rates as the key intermediate rate determined by market supply and demand. In sequencing interest rate liberalization, foreign currency interest rates will be reformed before those in local currency, rural rates before those for urban financial institutions, and bank lending interest rates ahead of deposit interest rates.

So, the main elements of the reform will involve relaxing restrictions on the yield at issue of domestic enterprise bonds, leaving these to be determined by the market; lifting controls over the deposit and loan interest rates of rural credit cooperatives and allowing them to set their interest rates according to the supply and demand of funds and the risk level of lending; and gradually expanding the allowable spread of lending rates for financial institutions in urban areas, to exercise control over retail deposit interest rates and a flexible management of large-amount deposit interest rates.

Comprehensive reform to gear the state-owned commercial banks toward modern banking

The basic objectives in the reform and development of the wholly state-owned commercial banks are to introduce best modern banking practice; to innovate the ownership system; to optimize ownership structure and corporate governance; to reform operations, management, personnel, and distribution; and to improve branch network. Quantitative targets will include keeping the average nonperforming loan ratio under 15 percent and minimum capital adequacy ratio at 8 percent.

The guiding principles of the reforms are "overall planning implemented through differentiated handling; dealing not only with evident problems but with their root causes; and achieving set goals within the designated timeframe". The focus of the reforms is to renew the banking system, turn the four wholly state-owned commercial banks into shareholding banks in ways suited to their respective conditions, and altogether achieve a fully modern banking system by around 2005. The main contents of the reforms will include:

- *Ownership and shareholding reforms.* Wholly state-owned enterprises are now more or less analogous to government departments. This has to change fundamentally, and the distinctive features of a financial enterprise must be taken into account if it is truly to be able to function on a commercial basis. Internal corporate governance must be built on sound principles. The supervisory board, the board of directors, and the management will have clearly defined responsibility. Then, viable wholly state-owned commercial banks should be allowed to reorganize into share-holding banks, with the state holding the controlling share to create the conditions for being listed in the future.

- *Improving the institutional setup.* The branch layout will be based on cost, efficiency, and profitability considerations. At the same time, internal structures must ensure both an effective division of labor and internal controls.
- *Exercising a prudent accounting system, gradually alleviating historical burdens, and improving the quality of assets.* In this respect, it is necessary to make proper readjustments to accounting standards; reform the system of provisions for and writing off loan losses; explore ways of reforming the tax rates for commercial banks; roll out the risk-based five-category loan classification system already being introduced; and evaluate the issue of nonperforming loans resulting from policy factors with a view to relieving the commercial banks of their historical burdens.
- *Enhancing capital adequacy through various channels.* An improved capital replenishment system for commercial banks has to be established in mutual support with reform of the ownership structure.
- *Strengthening external supervision mechanisms.* Two steps can be taken to increase the transparency of the wholly state-owned commercial banks and bring the information disclosure of the Chinese banking industry up to international standards. The first is to modify the accounting system of the banking industry and provide incentives for the commercial banks to disclose information not directly relating to their performance and gradually increase disclosure frequency. The second is to increase the disclosure of information in business performance and financial situation.

China will also encourage the commercial banks to carry out business innovation and personnel and salary reforms to enhance the incentive system.

Stepping up the reform of the management system of rural credit cooperatives

Established according to the cooperative principle, the rural credit cooperatives are intended to help the vast number of farmers expand their market-based production and to support the development of agriculture and the rural economy. The focus of deepening reform in the rural credit cooperatives should be to clarify ownership and improve governance. The organizational form of rural credit cooperatives needs to be rethought in the light of the actual conditions of the cooperatives concerned. Their management has to be strengthened, with self-discipline and self-developing operational mechanisms put in place to ensure better incentives for good performance.

With the expanded spread of allowable interest rates and a continuation of low tax rates, the policy environment will remain supportive of the rural credit cooperatives, enabling them to deal with inherited burdens, lower risks and bring them under more effective control. Gradually, insolvent credit cooperatives will be disposed of. The business of the rural credit cooperatives has to develop in a comprehensive way, and their services have to be further improved to help the farmers get better access to loans. Shared services and self-regulatory umbrella groups or associations of cooperatives could be part of the solution for the rural credit cooperatives, while supervision by the PBC of the cooperatives has to be improved.

Speeding up development of the financial market

The financial market is an important vehicle for transmitting monetary policy. Its level of development affects not only the efficiency of capital allocation but also the operating efficiency of the central bank's monetary policy. In this connection, China must accelerate the deepening of the financial market and development of the money market. For one thing, there need to be nationally integrated multi-layered money markets open to all financial institutions. Efforts are also needed to further standardize and develop the interbank lending market, increase the number of market participants, develop the mechanisms for financing small and medium-sized financial institutions, and strengthen market regulation.

The financial institutions should develop over-the-counter bond transactions for both corporate and individual customers. What is envisaged is an integrated bond market structure consisting mainly of the interbank market supplemented by over-the-counter transactions with commercial banks. At the same time, the development of the bond market will also require better custody and settlement services. There needs to be a network of money market brokers and market makers. The financial institutions will be encouraged and guided to develop negotiable bills discount business. Efforts will also be made to promote the development of regional bills market and to try issuing financing bills so as to increase the range of bills eligible for discount.

A second need is to promote the development of the Chinese capital market. Improving corporate governance in the securities industry, building up the market system, and enhancing supervisory and regulatory skills constitute three priorities in the future capital market reform. To protect the interests of investors and standardize the operations of the listed companies, China will, according to the criteria set by the OECD and in the light of the actual conditions in China, work out principles for corporate governance, enhance the level of information disclosure by listed companies, and improve supervision and regulation.

A third need is to establish a scientific and reasonable normal financing relationship between the money market and the capital market—to support the development of the capital market, ward off financial risks, and give further play to the role of monetary policy in macroeconomic development. Access by securities dealers to the lending market must be put under close scrutiny to prevent illegal lending by the securities dealers. The stock-pledged loan business of the commercial banks will be further standardized, with strict review and approval over the qualifications of the commercial banks and securities companies conducting such business. Securities dealers will be encouraged to finance through bond repurchase and bond issuance.

Improving the managed floating exchange rate regime

Although the single managed floating exchange rate based on market supply and demand, in place since 1994, has served China and the region well it is still too rigid. It needs to be improved so that the exchange rate can better reflect real market supply and demand as well as changes in balance of payments performance.

The objective here is to increase the flexibility of the yuan exchange rate system and widen the range of float. To this end, China will gradually increase the role of the market in influencing the exchange rate, widen the range of float for the interbank market exchange rate, adjust the limits on banks' working positions, and reform the foreign exchange surrender system. Efforts will also be made to further develop and improve the foreign exchange market by promoting forward foreign exchange surrender and purchase business, extending business hours for interbank foreign exchange market, promoting big-volume agent trade and increasing the variety of products for the foreign exchange market. The intervention mechanism of the central bank will be improved by shifting the exchange rate target for the yuan from the U.S. dollar to a basket of foreign currencies, reducing the frequency of central bank intervention in the foreign exchange market, and strengthening monitoring and early warning over the foreign exchange market.

Actively creating conditions and the gradually relaxing control over capital account

Although current account convertibility was introduced in December 1996, strict control is still exercised over capital account items. International experience suggests that capital account convertibility requires a stable macroeconomic environment, a sound financial system, effective supervision and regulation, and a resilient overall national economy. China will act cautiously and pragmatically, gradually creating the basic conditions for capital account convertibility. Thus the authorities' capacity for maintaining macroeconomic stability through instruments of monetary and fiscal policy, as well as the exchange rate, will be strengthened. Efforts will be made to enhance the ability of domestic industrial, commercial, and financial enterprises to build the capacity to use, earn, and repay foreign exchanges. It is also important to improve the fiscal balance and promote price stability. The financial market will be standardized, the securities market expanded. Supervision and regulation of financial institutions will also focus on their ability to absorb international capital shocks.

Further opening the financial market in an orderly manner

Against the backdrop of increasing globalization, China has worked out a preliminary timetable for opening the financial market. In the year of China's entry into the WTO, foreign banks will be allowed to conduct foreign currency business with Chinese enterprises and individuals. Two years after that, they will be permitted to conduct yuan business with Chinese enterprises. In another three years, they will be allowed to conduct yuan business with the Chinese individuals. Within five years of China's entry into the WTO, the number of cities where foreign banks are allowed to conduct yuan business will gradually increase. Foreign banks will not be under geographical restrictions in conducting yuan business and will fully enjoy national treatment.

Strengthening financial supervision and ensuring financial and economic safety

The quality of central bank supervision and enforcement of prudential rules in line with international standards constitute an important guarantee for economic and financial safety. The central bank must speed up the reform of the supervisory and regulatory system, enhance the independence and professionalism of the financial regulatory authorities, and improve its ability to coordinate financial supervision and monetary policy, control moral hazard, and identify and cope with banking risks. To this end, reform of the banking supervision system will be carried out in accord with the principles of separating regulation from supervision (separating administrative and planning work from direct supervision), supervising legal persons (the focus of supervision to be on the financial institutions as legal persons, rather than on their branches), and clearly defining responsibilities (the supervisory groups and individuals carrying responsibilities for direct supervision). The purpose is to increase the ability and quality of supervision by the central bank. While reforming bank supervision, China will also reform the accounting system, enhance the self-discipline and supervision of the industry, and give full play to the supervisory role of law firms, accounting firms, rating agencies, and other intermediary organizations.

In short, China is aiming to enhance the quality and efficiency of its financial system, to the best modern standards and as soon as possible, to facilitate the economy's stability and development.

France

France's liberalization of its capital controls, implemented between 1983 and 1990, was an indisputable success. The process occurred quickly: between 1984 and 1988 France switched from high protection to an almost entirely deregulated environment, phasing out all controls on the trade balance and the current account. Moreover, the process was not detrimental to macroeconomic fundamentals. On the contrary, it was accompanied by a restoration of economic stability. The trade balance improved significantly, and the French franc stabilized. The last adjustment of the exchange rate occurred in January 1987, with a 3 percent devaluation of the franc relative to the Deutsche mark.

The franc's strong resilience to the currency crises of the early 1990s indicates the success of these efforts. Unlike some European currencies, the franc was never forced out of the European Monetary System—though its defense demanded repeated use of joint foreign exchange interventions, reducing the Bank of France's official currency reserves. France's approach to liberalization enabled it to join the European Monetary Union when it was created in 1999, with a conversion rate that maintained the 1987 value of the franc. Moreover, countries such as Greece, Japan, Portugal, and Spain have used progressive approaches similar to France's to liberalize their capital controls.

The reasons for France's success are diverse and partly due to noneconomic and external factors, such as political commitment and economic recovery from 1986 onward. Still, three features of France's liberalization policies made decisive contributions to their success: the policies were pragmatic, integrated, and flexible:

- *Pragmatic approach.* Ideology played as small a part in the process of liberalization as it had previously played in the institution of capital controls. From the beginning the priority was not to expedite the process at any price (through a "big bang" approach) but to ensure an incremental process—while eliminating any possibility of retreat, which would have imposed heavy credibility costs. Enormous attention was paid to sequencing, and the government moved to the next stage only after the previous one had achieved satisfactory results.
- *Integrated design.* The process was not focused solely on removing capital controls. Each stage of capital control liberalization proceeded hand in hand with macroeconomic stabilization and structural reform because both were crucial to strengthening the economy and so ensuring the durability of the reforms.
- *Flexible implementation.* Implementation was flexible, enabling faster liberalization whenever the economy allowed it. As a result the entire liberalization process was completed in 1990—six months ahead of schedule.

This chapter analyzes France's experience with capital controls and the evolution of their liberalization in four stages since World War II.

Rationale for financial account controls from World War II to the 1980s

France has long recognized the advantages of liberalization. Still, at several points in the 20th century it resorted to capital controls to prevent adverse dynamics that would induce a major worsening of its economic fundamentals. France's stance during this period can be summed up this way: as much liberty as possible, as much control as necessary.

BOX 1

Steps toward financial deregulation in France, 1948–97

1945–65: The "Treasury network"

- Banking system organized under the direct control of the government (a result of the nationalization of 1945).
- Administrative control of savings and credits.
- System of credit quotas.
- Financing of the economy lay in the hand of the Treasury, which was financed by the central bank and commercial banks (through Treasury bonds). Bank credit was limited by discount ceilings.

1966–83: The supremacy of the universal bank

- Birth of the universal bank following laws in 1966 and 1967 allowing the free creation of branches.
- Creation of capital markets—opening of the currency (monetary) market, creation of the mortgage market, settlement of the *Commission des opérations de Bourse*—to ensure that banks and the economy had the required financing and to ease reserve requirements.
- Persistent quotas on credit (1968–69, 1972–86) in a system dominated by financial intermediaries.
- Diversification of deposits to channel savings to banks (creation of housing savings in 1966 and 1969).

1984–97: Liberalization and European coordination

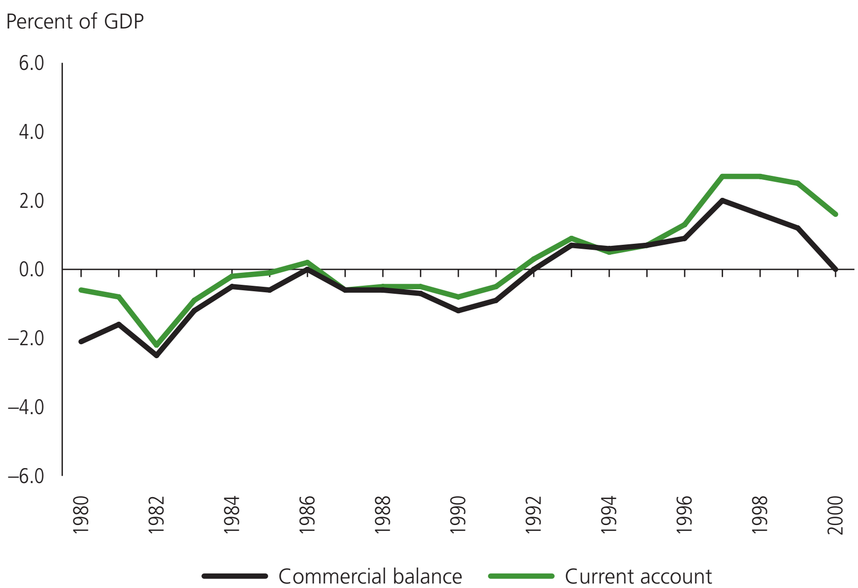
Liberalization

- Widening and deregulation of capital markets organized by the government (1982–85)
- Regulatory harmonization of credit institutions and banking deregulation (banking law of 1984).
- Removal of credit quotas in favor of regulation based on the leading interest rate of the Bank of France.
- Privatization from 1986 on, with two waves: 1986–88 and 1993–95.
- Implementation of a system of prudential controls, partly within the framework of the central bank's coordination process (based on Basle guidelines).

European coordination

- Gradual phasing out of banks' reserve requirements (1991).
- Liberalization of bank activities in the European framework (1988–93).
- Harmonization of prudential regulations (1989–96).
- Enforcement of the EU directive on investment services (1996) through France's law on modernization of financial activities.

Figure 1. Commercial balance and current account in France, 1980–2000



Most of France's capital restrictions were imposed in the wake of exogenous shocks. Thus exchange rate controls were tightened in 1939. But in 1958, in the wake of political stabilization, payments related to current transactions were liberalized, ensuring free convertibility for current operations by nonresidents. In 1961 France, like other Western European countries, restored current account convertibility, accepting the obligations of the International Monetary Fund (IMF) articles of agreement—which define members' obligations on, among other things, convertibility of foreign-held balances and avoidance of discriminatory currency practices and restrictions on current transaction payments. Surveillance concerns the appropriateness of changes such as the introduction of capital controls and substantial modifications in this area for balance of payments purposes. France's capital controls have always respected the IMF articles of agreement.

Until 1966 foreign exchange controls focused exclusively on capital flows, but at the end of that year a law abolished residual foreign exchange controls. The magnitude of the events in May 1968, however, forced the French authorities to re-establish such controls in November 1968.

Capital controls were not conceived as a way to escape market pressures. On the contrary, the French authorities benefited from the protection offered by regulation to gradually increase the role of the market within the financial system. Although from 1945 to 1965 the government assumed control for financing the economy (through administered yields of savings, grants to public financial institutions, and selective credit distribution; see box 1), from 1965 to 1983 the government partly disentangled itself from the direct financing of investment and promoted the development of banking intermediation.

Starting in 1966, various laws increased the autonomy of banks, allowing them to distribute long-term credits financed by short-term resources. In addition, barriers to the opening of branches were abolished, giving banks the opportunity to build up networks to collect resources. New laws also provided the framework for the creation of groups, ensuring through the principle of nonyielding deposits cheap and abundant resources to commercial banks. And with the creation of the mortgage market, the refinancing market was widened.

From the first oil shock until the early 1980s, commercial banks' refinancing was eased by the possibility of discounting medium-term credits to the central bank. French banks also increasingly turned to external markets. In 1980 more than 90 percent of the cash in circulation was invested in commercial banks, confirming the hegemony of the universal bank.

In the early 1980s deterioration in France's commercial and current account deficits and the large differential in its nominal interest rates with Germany put pressure on the exchange rate by offering speculative opportunities against the French franc (figures 1, 2, and 3). Thus in 1983, after speculative attacks against the exchange rate and three devaluations of the French franc in 18 months, the authorities decided to tighten exchange controls. These measures were intended to prevent evasion through the use of leads and lags in current account transactions and to prohibit all forward exchange transactions by importers and exporters. In 1983 severe cuts in foreign travel allowances were also imposed.

Figure 2. Interest rate differential between France and Germany, 1980–2000

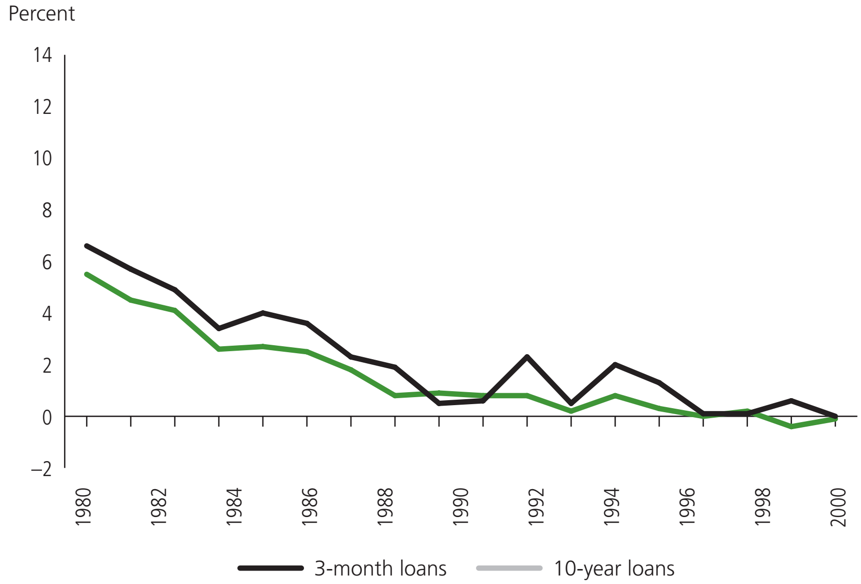
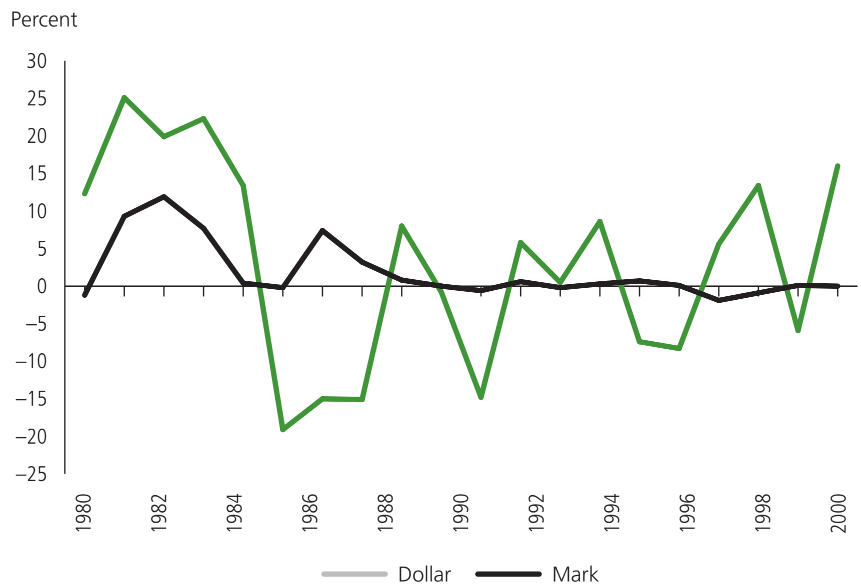


Figure 3. Exchange rate of the Deutsche mark and U.S. dollar relative to the French franc, 1980–2000



At that point, however, the costs of capital controls had become huge, both economically and politically. Capital control regulation entailed significant management costs for both the public administration and the private sector. Beyond these costs—which prevented small and medium-size companies from developing exports—tight capital controls were significantly detrimental to the internationalization of French companies. Not only did they limit export dynamics, they also hampered the takeover of foreign companies.

Capital controls also threatened the role of Paris as a major financial marketplace. By discouraging nonresidents from investing in domestic securities, they limited incentives to modernize the functioning of the market at a time when national savings had dropped significantly due to a fast-rising public deficit.

France's liberalization process, starting in 1983, was partly driven by international deregulation and by the development of the EU. Several measures were introduced:

- Deregulation and opening of capital markets.
- Unification of the legislative framework of credit institutions (through the banking law of 1984).
- Modernization of the management of general government debt by fitting out Treasury bonds.
- Suppression of the squeeze on bank credit (in 1987).
- Reduction of government intervention in financing, which fell sharply between 1985 and 1992.
- Privatization of the largest industrial and banking groups (starting in 1987).

Liberalizing capital controls was not easy. Nevertheless, the phasing out of capital controls was carefully designed and implemented in only a few years. To ensure price and domestic currency stability during the process, the pace of capital control liberalization had to remain in line with improvements in macroeconomic fundamentals. In most cases that meant that liberalization had to be gradual. But given the degree of global financial sophistication and market pressure, a gradual approach was difficult to implement. Thus sequencing and macroeconomic consistency were two key issues in capital control liberalization.

The first two periods of the liberalization process both involved an important leap forward. From 1984 to 1986 emphasis was placed on the most pressing priority—namely, liberalization of trade-related operations. From 1986 onward, liberalization efforts mainly concerned the financial system. The last step, from 1987 to 1990, was dedicated to phasing out residual foreign exchange transactions and liberalizing foreign direct investment inflows.

Liberalization of trade and the move to a market-financed economy, 1984–86

In 1983 most operations involving financial relations abroad were controlled. Whereas most capital restrictions on the financial sector involved state-owned banks, which experienced very tight credit controls, most foreign exchange controls affected companies involved in international trade and were especially detrimental to the smallest ones—those most ill at ease with administrative proceedings and least able to cope with the costs.

The liberalization process began with the phasing out of restrictions on French citizens. Such restrictions were the most politically sensitive because they were considered to interfere with privacy and individual freedom. As of mid-1983 discretionary private transfers were allowed under a ceiling that increased gradually through 1986. At the end of 1983 the famous *carnet de change* (foreign exchange voucher) limiting currency buying from French tourists was removed. The year after, the free use of credit cards abroad was re-established.

At the same time, decisive measures were taken to restore fundamental macroeconomic balances. Decisive steps were taken to restore price stability. In 1982 and 1983 wages were progressively de-indexed. This important reform paved the way to a better control on inflation anticipations, leading to a sharp and durable decrease in inflation. Meanwhile, the restructuring of French companies speeded up. The capital base of the largest companies was improved through nationalizations that shored them up with fresh capital and helped restructure the main industrial sectors. The profitability of the French corporate sector improved markedly. This enabled French companies to finance their development more with their cash flow rather than with bank loans.

In 1985 the launching of the Single Market process provided a further incentive to remove barriers on trade. In 1985 currency hedging for ECU-denominated imports was allowed. That same year, restrictions on export credits were lifted. In mid-1986 a decisive step was taken: currency hedging was totally liberalized and some flexibility was introduced in foreign cash management. In late 1986 administrative controls of trade transactions were entirely removed.

The liberalization of capital transactions presupposed a prior mutation of the financing structures of the French economy. Financial deregulation took place in France within a couple of years, from 1984 to 1986. During this short period the French economy moved from a situation characterized by a wide range of administrated rates, a relative scarcity of financial instruments, and credit rationing and regulation (known as *encadrement du crédit*) to a market-based economy. These huge changes affected both the conduct and the efficiency of monetary policy.

The Banking Act of 1984 can probably be considered a cornerstone for these changes. This act, replacing 1941 and 1945 legislation, removed old divisions between investment and commercial banks. It also introduced new, uniform prudential rules for all financial institutions.

The deregulation process can also be traced back to 1984, when the end of the *encadrement du crédit* was announced for January 1985. This credit rationing had been introduced by the French monetary authorities in 1972 to help the monetary authorities control monetary aggregates. But the conduct of monetary policy turned out to be more complex than expected because the regulation was subject to many exemptions for a wide range of subsidized credits. It also created many distortions, leading to artificial pressures on interest rates and generating high administrative costs. With the demise of direct credit control, the French monetary authorities began to rely exclusively on interest rates and legal reserve requirements for monetary management.

The monetary authorities also reformed the money market by dividing it into two distinct segments. The first, the interbank market, was open only to financial institutions and was the segment on which the French central bank operated. The second, the new money market, was gradually opened to all economic agents and focused on debt instruments of all maturities (from overnight to seven years). Moreover, banks were allowed to issue certificates of deposit, while firms were permitted to float commercial paper. At the same time, the purchase of Treasury bills was opened to everyone.

The crowning change occurred in late 1986 with the reform of the Bank of France's money market intervention techniques and the end of "fixing"—which had meant that every morning the central bank announced the price at which it would deal during the day, setting a standard for all transactions. Once this practice ended in December 1986, prices started to vary continuously, and different prices started being quoted simultaneously. In line with the reform in money markets, from 1986 onward the Bank of France started to intervene more frequently on the market, either through outright transactions or through very short-term repurchase and withdrawal transactions for fine-tuning purposes, without any formal announcement. Because of all these changes, the French economy—which had been enormously reliant on banking for finance—became increasingly dependent on internal finance and capital markets.

Although it is difficult to assess the impact of all these changes on the transmission mechanism of monetary policy, some econometric research has indicated increased efficiency. Comparing two periods, 1987–91 and 1992–96, Pfister and Grunspan (1999) show that the responses of money market rates and bank lending rates became quicker and larger in the second period (Pfister and Grunspan 1999). The same conclusion can be drawn about the impact of changes in interest rates on the exchange rate, because the interest rate rise required to alleviate exchange rate pressure became progressively less important.

The link between foreign exchange controls and structural reforms is utterly clear during this period. France never considered foreign exchange controls a substitute for monetary policy, but the restoration of structural conditions conducive to price stability was clearly a prerequisite for relaxing such controls. In fact, foreign exchange liberalization measures entailed significant costs for France's currency balance that would have been incompatible with a continuous strain on foreign exchange reserves. Macroeconomic improvements and the positive effect on confidence in France's economic policy—along with the credibility effect resulting from membership in the European Monetary System—eased pressure on the franc and made possible the moves toward foreign exchange liberalization.

Liberalization of most capital transactions, 1986–87

Until the mid-1980s the financial sector in France was controlled by the state through a wide range of tools: compulsory reserves from commercial banks in the central bank's books, direct credit control, shareholding control of the state in the largest banks, and subsidized loans to the industrial and agricultural sectors.

The mutation of the banking sector was accelerated by the desire to boost the competitiveness of the Paris marketplace and by the state's need to deal with rapidly increasing borrowing requirements by attracting nonresident savings. These factors led to deep reform of the French debt market. A structured monetary market was created with three kind of issuers: the state (with Treasury bills called *Bons à taux annuel*, or BTAN, and *Bons à taux fixes*, or BTF), banks (with certificates of deposit), and private companies (with commercial paper called *billets de trésorerie*). The long-term debt segment was also restructured.

The sovereign debt market was organized around regular issuance of bonds (*obligations assimilables du Trésor*), all fungible in a small number of main lines. For market-making a system close to that of primary dealers was adopted with selection among both French banks and subsidiaries of foreign ones of *Spécialistes en valeur du Trésor*. Meanwhile, the stock market was dramatically modernized through dematerialized shares and electronic trading. In 1986 a futures market for bonds was created. In addition, commissions and fees for financial markets were completely deregulated.

These important changes made it possible to remove some important restrictions to cross-border financial operations. The legal framework for foreign currency-denominated loans abroad was relaxed in 1986. Franc-denominated loans abroad were allowed soon after. And in mid-1986 French residents were freely allowed to buy securities listed on foreign equity markets.

The framework for international investment also began to be loosened significantly. The acquisition of foreign real estate by French residents was fully liberalized. (It had previously been subject to authorization by the Bank of France.) In addition, investments by French residents in foreign corporations were relaxed in 1986. At that time, only investments in holding corporations were still subject to prior authorization from the Treasury (except for investments in South Africa, which were prohibited for political reasons).

Deregulation of foreign direct investment in France also made significant progress during this period. In 1986 the 10 million franc ceiling, above which additional interest-taking from nonresident companies in French companies were subject to administrative authorization, was removed.

Toward total liberalization of capital flows, 1988–90

Residual restrictions on capital flows were removed between 1988 and 1990. In 1998 the legal framework for exporting companies was simplified. In mid-1989 controls on the aggregate foreign exchange positions of commercial banks were abolished and replaced by prudential regulation. At the end of the year residents were allowed to freely open and keep foreign currency—denominated accounts in France and foreign currency—and franc-denominated accounts abroad as well as to hold monetary gold abroad.

All remaining administrative restrictions on foreign direct investment in France was also phased out during this period. In 1998 the settlement of nonresident-owned companies in France was fully liberalized and the creation of companies by nonresidents became entirely free. In 1990 the legal framework for investment by European Union companies in France was softened considerably.

This liberalization process did not mean a retreat in the statistical accuracy of the French balance of payments or in the fight against financial crime and money laundering. Banks are

BOX 2

Steps toward prudential deregulation in France, 1990–2000

The liberalization of international capital flows to France was accompanied by the implementation of a prudential framework derived from decisions made at the international level (the Basle committee) and at the European level. The importance of supervision and prudential rules has increased following the increased risks due to globalization and the difficulties due to the growing size of banks.

Derived directly from European Union directives, prudential regulation in France rests on two complementary principles: liberalization (mentioned in the banking law) and harmonization of regulations. Prudential rules are mainly based on classical banking risks. Norms have been elaborated for reporting banks' counterpart risks and exchange rate risks. Norms based on banks' assets and liabilities have also been constructed to reinforce the requirements and prevent liquidity risks. France's framework of prudential rules is quite strict—relative to financial institutions in other major European countries, those in France have to respect very specific rules.

subject to compulsory monthly declarations to the Bank of France (with direct declarations by large exporters), and specific legal provisions were designed to prevent money laundering. Cash transfers are limited to 50,000 francs (8,000 euros). Moreover, banks must alert an administrative crime-fighting unit any time account movements raise suspicions of money laundering.

The liberalization of capital movements was finalized through prudential deregulation and liberalization of foreign direct investment (box 2). In addition, the Bank of France was granted full independence thanks to new statutes implemented in 1993.

Reference

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Germany

Globalization has clearly had a favorable impact on productivity and economic development in Germany. The positive effects have been enhanced by the institutional setting—companies enjoy the economic freedom, political stability and legal security that enable them to make full use of the benefits of international interpenetration. Advantageous macroeconomic conditions arising from the low-friction interaction of fiscal, monetary, and wage policies have contributed to this development, as have state reforms, such as the privatization of state enterprises and liberalization of markets through the European single-market program, GATT, and the WTO.

The German economy also benefited from the early liberalization of capital flows in combination with a sound financial system and a monetary policy that was strictly oriented toward price stability. As a result, interest rates remained relatively low, the Deutsche mark became the second most important international currency and Germany developed into a major international financial center, contributing to growth and employment in Germany. The German experience also shows, however, that, in the context of free movements of capital, monetary policy can only be geared independently if the exchange rate has sufficient flexibility.

Social harmony has been preserved by means of comprehensive social security systems and state redistribution designed to cushion the adverse effects of accelerating structural change. In the light of rising unemployment, however, action must be taken with a view to reintegrating more quickly and more fully those who have become redundant—say, by introducing more flexible tools in labor market and wage policy, concentrating welfare policy on the losers from structural change or reducing the burden of contributions on enterprises and households. This could further minimize the risks of globalization and harness its benefits to a greater extent for the German economy as a whole.

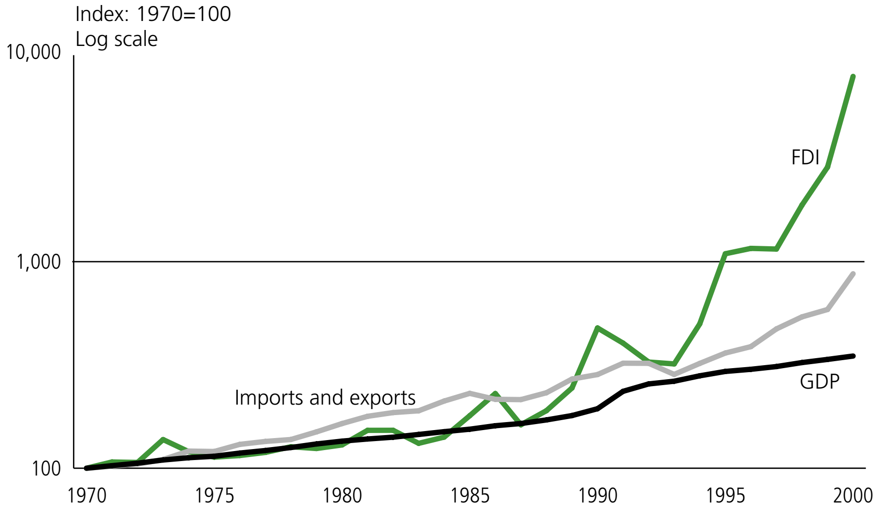
Indicators of globalization

The increasing integration of the global economy in products and production factors has led to noticeable changes in Germany. Foreign trade in goods and services has intensified. Cross-border investment is on the rise. And capital flows have become more liberalized. Foreign direct investment in Germany and investment by German enterprises abroad have been growing much faster than gross domestic product (GDP) since 1950, with annual growth rates averaging more than 30 percent in the 1990s (figure 1). Foreign trade linkages—the development of imports and exports—have also increased significantly, though not to the same extent as direct investment.

This process—beginning with the founding of the Federal Republic of Germany in 1949 and the subsequent economic reintegration of West Germany into the international division of labor in the 1950s—is from a qualitative viewpoint not fundamentally new. Instead, it is the resumption of developments interrupted by the outbreak of World War I.

Globalization, apart from the rapid reintegration of Germany into the global economy after World War II, has been a gradual process (figure 2). The degree of openness—the proportional role of imports and exports in GDP—has risen distinctly, moving from 20.4 percent in 1950 to 56 percent in 2000 in nominal prices. In constant prices the increase becomes more obvious, as the prices in foreign

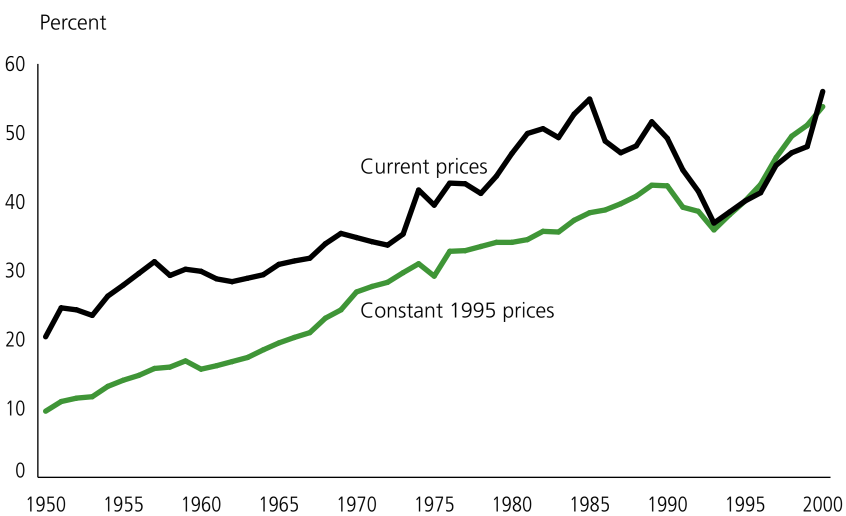
Figure 1. Indicators of globalization, 1970–2000



Note: Data are in current prices and refer to West Germany for 1970–90, Germany for 1991–2000. FDI equals the sum of FDI inflows and FDI outflows.

Source: Federal Ministry of Economics, Council of Economic Experts, Federal Statistical Office.

Figure 2. Degree of openness, 1950–2000



Note: Data refer to West Germany for 1970–90 (excluding Saarland and West Berlin until 1959), Germany for 1991–2000.

Source: Council of Economic Experts, Federal Statistical Office.

trade have risen less on average than the price index of total GDP. This has been influenced by the worldwide liberalization of trade through GATT and the WTO, the progress in European integration, and such technological and economic developments as the drastic reduction in transport and communications costs.

The almost constant rise in the degree of openness (in constant prices) was interrupted by German reunification in 1990. West German enterprises concentrated their marketing efforts on eastern Germany after reunification, giving other markets lower priority. In the 1990s, activity in foreign trade gained noticeable momentum with high growth rates in imports and exports, at times running into double digits.

The openness of the economy was supported by the integration of Germany's financial markets into the global financial system and the growing attractiveness and increasing importance of the Deutsche mark. Facilitated by an early liberalization of capital movements, Germany's cross-border assets and liabilities increased from less than 20 percent of GDP at the beginning of the 1960s to about 130 percent in 2000 (figure 3a). German investors currently hold nearly a fifth of their financial assets in foreign instruments. Likewise, German borrowers use external sources of capital to a similar extent. Purchases of German securities by foreign investors increased from less than 10 percent of the total net amount issued during the 1970s to about 60 percent between 1996 and 2000 (figure 3b).

The international orientation of the German banking sector is reflected by the steadily rising share of cross-border bank activities. In 1960 lending to nonresidents accounted for less than 2 percent of the total assets of the German banking sector. In 2000 that share amounted to 16 percent (figure 3c). German banks provide financial services around the world, directly and through almost 400 foreign subsidiaries and branches. Total assets of foreign subsidiaries and branches account for 35 percent of the balance sheet total of domestic institutions.

The internationalization of the German economy was mirrored by the enhanced role of the Deutsche mark, which in the 1970s became the second most important investment and reserve currency after the U.S. dollar. By the end of the 1980s, Germany's share of global foreign exchange reserves peaked at about 20 percent but began to decrease as developing countries, which traditionally favor the U.S. dollar, substantially expanded their foreign exchange holdings and some euro area countries reduced their Deutsche mark reserves in the run-up to European Monetary Union. By the end of 1998, when the euro was launched, the Deutsche mark share had dropped to 12 percent. At that time, 10.5 percent of international bonds and notes and 14 percent of international bank loans were denominated in Deutsche marks (figures 4a–c). The international integration of Germany's financial markets has facilitated financing activities for domestic borrowers. But market conditions in Germany were at times heavily influenced by external developments, affecting—at least temporarily—the impact of domestic monetary policy.

Given the German economy's increasing globalization, two questions are of particular interest:

- What have been the overall economic effects of the process of globalization?
- Which governmental measures have maximized the benefits of globalization and minimized its risks?

Institutional framework in Germany

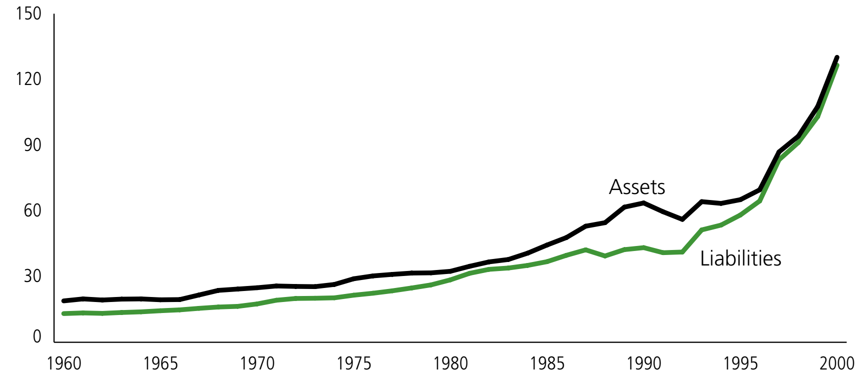
The economic and legal framework in Germany is based on a "social market economy". The most important elements of this economic order—which arose in West Germany at the end of the 1940s and, on reunification, took hold in eastern Germany—include private ownership of the means of production, free price formation, the guarantee of free competition, freedom of foreign trade, a low-inflation policy regulated by an independent central bank, and a policy of social equalization by governmental redistribution.

Highly relevant to harnessing the benefits of globalization are these fundamental elements and the interplay of individual institutional players in the economy. Through the pursuit of a sound fiscal policy, a stability-oriented monetary policy, and a wage policy guided by productivity growth and the labor market situation, favorable macroeconomic conditions can be created to encourage growth and employment in the face of exogenous import or supply shocks. The interaction among fiscal, monetary, and wage policies has been relatively successful in the past few decades, apart from

Figure 3. Financial indicators of the internationalization of the German economy

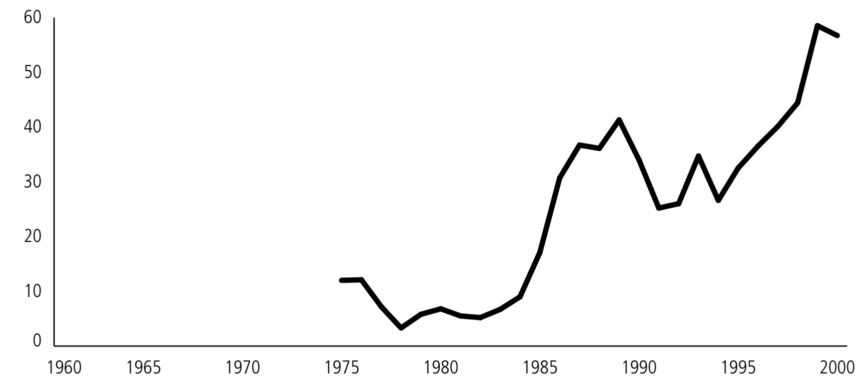
3a. Cross-border assets and liabilities

Share of GDP (%)



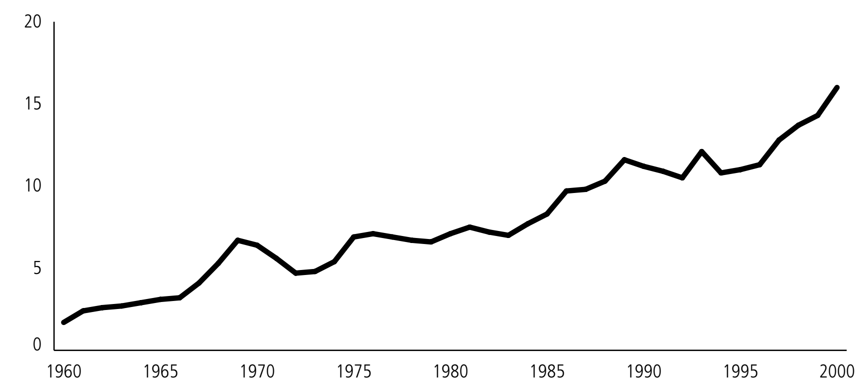
3b. Purchases of domestic securities by nonresidents

Share of net total issues (%), 5-year moving average



3c. Bank loans to nonresidents

Share of bank balance sheet total (%)

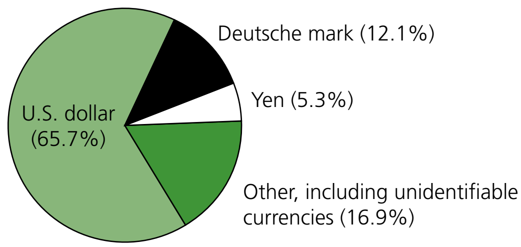


the severe conflicts surrounding distribution policy after the first oil crisis in 1973 and the wage policy in eastern Germany after reunification.

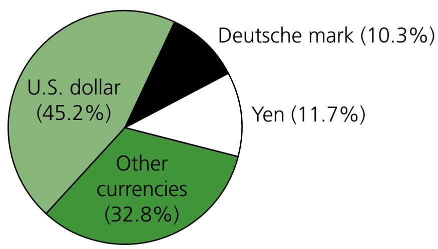
The advantages of globalization in Germany have been extensively exploited. Increasing internationalization has exposed

Figure 4. Market share of the Deutsche mark in international financial markets, end of 1998

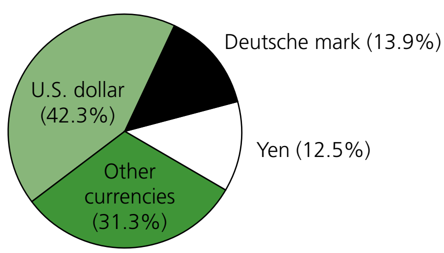
4a. Shares in global foreign exchange reserves



4b. Shares in international bonds and notes outstanding



4c. Shares in international bank assets[a]



a. Cross-border positions of the banks in the industrial countries reporting to the BIS.
Source: IMF, BIS.

German enterprises and business locations to more competition with foreign players. More intensive competition, increasing returns to scale in the production process and the exploitation of differences in international business locations have enhanced the efficiency of enterprises, bringing growth in productivity (table 1).

Moreover, the institutional framework favored German enterprises concentrating on capital-intensive and knowledge-intensive goods and services in the international division of labor, generating a higher net added value. German enterprises in the automotive, machine-building, chemicals, telecommunications, and electronics industries, characterized by medium to high technological intensity, feature a high share and intensity of export—a share that is still increasing (table 2). These increases in productivity, alongside constant or rising terms of trade, have resulted in welfare gains and left room for wage increases for employees.

The effects of globalization on the German economy cannot be clearly separated from the effects of technical progress. Both occur at the same time, reinforcing each other. Increasing international competition forces enterprises to step up their efforts in product development and optimization of production processes. Technological developments, such as the introduction of containers for maritime transport, have led to lower transaction costs and facilitate an increasing integration of international markets. There is no precise empirical answer as to which effect will ultimately dominate. But it clear that inter and intrasectoral structural change in Germany has gained momentum as a result of globalization.

Implementation of the international division of labor and specialization of production has been facilitated by the legal security, economic freedom, political stability, and social satisfaction prevailing in Germany. Such social aspects as state redistribution by progressive income taxation and social security as pension, health and unemployment insurance, and supplementary welfare benefits, have made globalization-driven change more palatable to the German public. But labor-intensive industries such as textiles, clothing, and leather processing have lost their international competitiveness in the lower price segments, which in turn has led to job losses.

Developments in eastern Germany after reunification emphasize the importance of social equalization for maintaining social satisfaction and avoiding political unrest. The vast majority of eastern German companies became uncompetitive in 1990/91, with radical structural change the inevitable consequence. Social cushioning of the blow of structural change was particularly important.

Compensation of the "losers" of the structural upheaval in Germany can be seen in income distribution. In recent decades, the distribution of household incomes has changed little despite rising unemployment. The systems of social security and progressive taxation have maintained the status quo. The Gini coefficient, a measure of the distribution of income, has risen only slightly in both western and also eastern Germany (table 3).

Political reforms

In addition to the national institutional setting, the benefits of globalization have been maximized in two different ways:

- Improving the quality of Germany as an economic location—asserting a leading position on the international market and exploiting the benefits of the increasing interpenetration of the domestic and foreign markets.
- Introducing legally binding international regulations through national, regional, and worldwide political reforms in educational policy, the privatization of state enterprises, and the liberalization of financial and commodities markets.

Education policy

The average level of education is on the rise—thanks to education policy, which in recent decades has focused on fostering higher educational qualification in schools and universities as well as on expanding the dual system of in-service vocational training. This can be seen in the higher numbers of qualified school leavers, university graduates, and qualified in-service trainees per year. With their higher qualification, employees have become more productive—a prerequisite for making better use of the opportunities offered by structural change.

Due to the accelerated pace of structural change, educational policy also plays an important role in the further training and qualification of employees. Unemployed workers not having the required expertise and skills need retraining—with help from the state—to facilitate their integration into the job market. Although the need for lifelong education has been a stronger focus of educational policy over the past few years, efforts still need to be reinforced for underskilled workers.

TABLE 1
Indicators of economic development, 1950–2000

Period	1951–60	1961–70	1971–80	1981–90	1991–2000	1951–2000
GDP[a]	8.9	4.4	2.7	2.2	1.5	4.0
Per capita GDP[a]	7.6	3.5	2.6	2.0	1.2	2.9
Productivity[b]	5.8	4.2	2.6	1.7	1.7	2.7
Rate of inflation[c]	1.9	2.5	5.0	2.6	2.2	2.8

Note: Data refer to West Germany for 1951–90, Germany for 1991–2000.
a. Constant 1995 prices.
b. GDP per employee, constant 1995 prices.
c. Annual average change in consumer price index.
Source: Federal Statistical Office.

TABLE 2
Structure of German foreign trade with respect to technological intensity, 1976–78 and 1992–94
(percent)

		1976–78	1992–94
High-technology industries[a]	Share of exports	10.7	15.0
	Share of imports	11.6	18.8
	Intensity of exports[c]	34.3	46.1
	Import penetration[d]	27.3	46.7
Middle-technology industries[b]	Share of exports	54.6	54.8
	Share of imports	29.4	36.6
	Intensity of exports[c]	34.3	39.6
	Import penetration[d]	15.7	26.4
Other industries	Share of exports	34.7	30.2
	Share of imports	59.0	44.6
	Intensity of exports[c]	15.3	19.4
	Import penetration[d]	16.9	22.6
Total manufacturing	Intensity of exports[c]	24.0	30.6
	Import penetration[d]	17.3	26.6

Note: More recent data not available due to statistical changes in the OECD STAN Database. Data refer to West Germany for 1976–78, Germany for 1992–94.
a. Among others, information technology, telecommunications, and aerospace.
b. Among others, chemicals, electronics, machinery, and cars.
c. Exports in percent of gross output.
d. Imports in percent of domestic consumption (gross output + imports – exports).
Source: OECD.

TABLE 3
Development of income distribution, 1984–98
(Gini coefficients)[a]

	West Germany		East Germany		Germany	
Year	Market income[b]	Net income[c]	Market income[b]	Net income[c]	Market income[b]	Net income[c]
1984	0.4276	0.2778	—	—	—	—
1988	0.4099	0.2665	—	—	—	—
1991	0.4064	0.2770	0.3920	0.2254	0.4254	0.2967
1995	0.4304	0.2891	0.4439	0.2316	0.4380	0.2856
1998	0.4446	0.2919	0.4815	0.2435	0.4550	0.2885

a. A Gini coefficient of zero implies a completely equal distribution of incomes; one implies a completely unequal distribution.
b. Gross income before taxes and transfers.
c. After taxes and including transfers.
Source: Council of Economic Experts, Federal Statistical Office.

Liberalization and deregulation of financial markets

Capital controls in Germany had been widely dismantled by 1958 when full convertibility of the Deutsche mark for residents and nonresidents was introduced. In the 1960s, the liberalization of interest rates followed, and in the 1980s and 1990s German authorities made significant efforts to strengthen the attractiveness of German financial markets by adjusting or removing domestic regulations that had narrowed the available array of financial instruments.

An independent monetary policy geared to maintaining price stability, the increasingly free flow of capital among industrial countries, and the Bretton Woods regime of fixed exchange rates soon proved to be incompatible policy objectives. To mitigate inflationary pressures from strong speculative capital inflows, Germany introduced measures from 1960 onwards to stem the growing international demand for Deutsche mark assets, including a ban on the payment of interest on nonresidents' deposits in domestic banks, a coupon tax levied on the interest nonresidents earned on domestic bonds, and the requirement of holding non-interest-bearing cash deposits against borrowings from abroad. (For an overview of the restrictions and the subsequent liberalization measures see appendix A.)

Abandoning the peg to the U.S. dollar in 1973 enabled the Bundesbank to regain control of the money supply. Floating was a particular precondition for the targeting of monetary aggregates introduced by the Bundesbank in 1974. Most restrictions on capital inflows were then quickly removed. The experience of the Bretton Woods era was reinforced by the developments in the European Monetary System in the early 1990s. Divergent economic developments called for different policies in the member countries. With more EMS countries having fully liberalized their capital account transactions, greater flexibility in the Exchange Rate Mechanism (ERM) was realized with the widening of the permissible fluctuation margins to ±15 percent in 1993.

The Bundesbank's constant efforts to ensure a high degree of price stability have resulted in the prevalence of long-term financing in Germany. In the same vein of fostering sound financing structures, the German authorities had not permitted the issuance of new types of paper such as floating rate notes, zero-coupon bonds, double-currency bonds, bonds linked to currency and interest rate swaps, or certificates of deposit. In 1985–86, in an effort to promote Germany as an international financial center, those regulations were abolished in connection with other measures to deregulate the German financial markets. Overall, the efficiency of German monetary policy has been safeguarded in an environment of liberalized and deregulated financial markets.

Liberalization of commodities markets and privatization

In addition to the liberalization of financial markets, numerous commodities markets, such as telecommunications and electricity, have also been liberated from restrictive state regulations. In both sectors, the opening of the market was originally triggered by the European single-market program. Liberalization has also been achieved in the financial services sector (banks and insurance companies) and in the transport sector thanks to the European single market as well as the gradual abolition within the European Community and European Union of nontariff trade barriers such as product standards.

This process has been accompanied on the part of the German government by increased privatization (for example, of Deutsche Telekom on the telecoms market), to make the former state monopolies more competitive. The partial privatization of the national postal service, Deutsche Post, and the national railway company, Deutsche Bahn, has been initiated and in part already completed.

Through GATT and the WTO, successful multilateral negotiations have led to a substantial reduction in tariff and nontariff trade barriers. The Uruguay Round of the GATT negotiations included a further reduction in customs duties (figure 5), the inclusion of textiles and agricultural in the regulations of the WTO and the admittance of services for the first time. Moreover, acceptance and the efficiency of the world trading system received support in the form of the agreement on international rules for the settlement of disputes. Importers and exporters in all WTO member states now enjoy even greater market access.

Minimizing the risks and maximizing the benefits of globalization

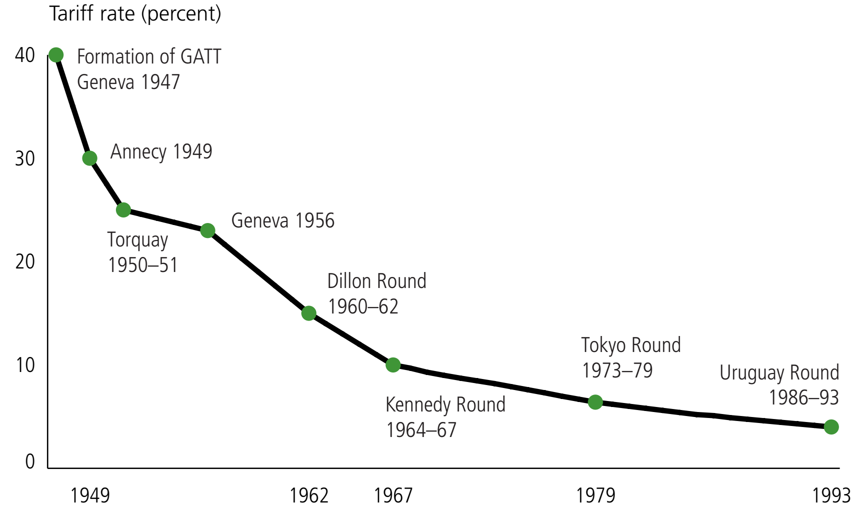
The stepping-up of liberalization and privatization has raised the intensity of competition on major markets (see export intensity and import penetration in table 2). It has also accelerated the pace of structural change and resulted in lower prices, which have made enterprises more competitive. It has also become possible for new, innovative technologies, such as mobile telephony, to be more widely used. Intensive entrepreneurial competition favors technological development and product differentiation, which can increase national and international sales and thus overall employment.

The unemployment trend in Germany demonstrates that the economic benefits of structural change can be put to even better use. The unemployment rate has been rising appreciably since the mid-1970s (figure 6), partly because the demands posed by the accelerated pace of structural change were not adequately met. Underskilled workers, in particular, are the people who have lost out in the structural change over recent decades. Their unemployment rate in 1999, at about 24 percent in western Germany and about 55 percent in eastern Germany, was clearly above the average (11.7 percent). Almost half the unemployed in western Germany received no vocational training. Extensive retraining and further training measures have, however, only succeeded in slowing, rather than halting, this negative trend.

One reason for the particularly sharp rise in unemployment among underqualified persons is the divide between their productivity and remuneration. When wages rise faster than productivity, it is less profitable to employ poorly qualified persons. Technical progress and growing international competition from developing and newly industrializing countries have led to the substitution of simple labor with capital or to the relocation of production facilities to countries with lower labor costs. The wage drift—with higher wages in Germany than in the international market— is too small to integrate all employees who have become redundant as a result of structural change. There is potential for making greater use of the benefits of globalization for all employees.

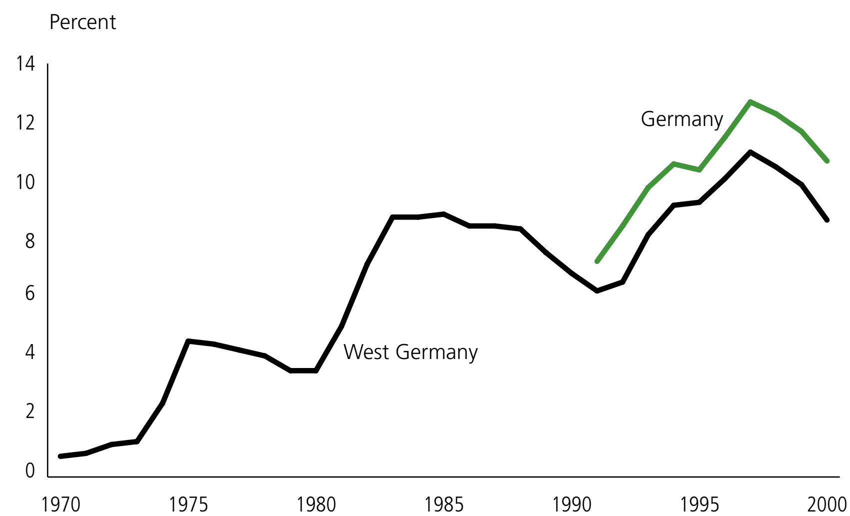
The downside of the all-embracing welfare system and state redistribution is the great burden borne by enterprises and private

Figure 5. Tariff reduction within GATT, 1947–93



Note: Average tariff rates of GATT members after completion of each round.
Source: WTO.

Figure 6. Unemployment rate, 1970–2000[a]



a. Unemployed persons as a share of the civilian labor force, national definition.
Source: Federal Labor Office.

households in taxes and social insurance contributions. The overall burden—the proportion of the GDP accounted for by taxes and social insurance contributions—rose from some 34 percent in 1960 to some 43 percent in 2000. This growing burden has reduced the incentives for companies and private households, turned labor into a more expensive factor of production, and weakened the international competitiveness of enterprises. There are still opportunities for maximizing the benefits of globalization, for example by concentrating welfare policy on the obvious losers in the process of structural change or reducing the marginal burden in the tax-transfer system, particularly for poorly qualified persons, to give them greater incentives to take up employment.

Lower tax and social insurance contributions would improve the position on the international market of domestic companies as well as that of Germany as an economic location and unemployment could fall—without jeopardizing the necessary solidarity with the obvious losers in the process of structural change. The reforms implemented in recent years, such as consolidation of state finances or tax and pension reform aimed at lowering contributions and raising incentives, are a step in the right direction. But these reforms must be followed through if the necessary reduction of contributions in real terms is to be sustained.

Appendix A

Record of Important Measures for Controlling Capital Imports into Germany, 1958–84

1958

December

- Introduction of full convertibility of the Deutsche mark for residents and nonresidents.

1959

May

- Removal of the ban on the payment of interest on foreign deposits with domestic banks and the authorization requirement for nonresidents' purchases of money market paper and the taking up of foreign loans with maturities of up to five years.

1960

June

- Ban on the payment of interest on foreign deposits with domestic banks, on the sale of domestic money market paper to nonresidents, and on securities transactions under repurchase agreements between residents and nonresidents.

1961

September

- Entry into force of the Foreign Trade and Payments Act and adoption of the principle of basic freedom of foreign trade and payments; no material change to the existing state of capital transactions.

1965

March

- Introduction of coupon tax on nonresidents' interest income from domestic bonds.

1968

November

- Introduction of the authorization requirement for the acceptance of foreign funds by domestic banks in so far as it does not serve the proper handling of merchandise, services, and capital transactions with foreign countries.

1969

February

- Removal of the authorization requirement for the acceptance of foreign funds by domestic banks.

December

- Removal of the ban on the payment of interest on foreign deposits with domestic banks, on the sale of domestic money market paper to nonresidents, and on securities transactions under repurchase agreements between residents and nonresidents.

1971

May

- At the beginning of the dollar crisis, reintroduction of the authorization requirement for the sale of domestic money market paper to nonresidents and for the payment of interest on foreign deposits with domestic banks.

1972

March

- Introduction of the cash deposit requirement for borrowings abroad. Exceptions are, in particular, credits in connection with the use of customary terms of payment and credits related to specific goods and services supplied. The cash deposit ratio is initially 40 percent with an exemption limit of 2 million Deutsche marks.

June

- Introduction of the authorization requirement for nonresidents' purchases of domestic bonds from residents.

July

- Raising of the cash deposit ratio to 50 percent and reduction of the cash deposit exemption limit to 500,000 Deutsche marks.

1973

January

- Reduction of the cash deposit exemption limit to 50,000 Deutsche marks.

February

- Extension of the authorization requirement for the purchase of domestic securities by nonresidents to equities. Introduction of the authorization requirement for residents' borrowing abroad.

June

- Introduction of the authorization requirement for the assignment of domestic claims to nonresidents.

1974

February

- Raising of the cash deposit exemption limit to 100,000 Deutsche marks and reduction of the cash deposit ratio to 20 percent. Restriction of the authorization requirement for the sale of domestic securities to nonresidents to bonds with (remaining) maturities of up to four years and removal of the authorization requirement for residents' borrowing abroad.

1974 (continued)

September

- Removal of the cash deposit requirement and the authorization requirement for the assignment of domestic claims to nonresidents.

1975

September

- Removal of the authorization requirement for the payment of interest on nonresidents' deposits with domestic banks and further relaxation of the authorization requirement for the purchase of domestic bonds by nonresidents.

1980

March

- Allowance of the possibility of assigning official borrowers' notes to nonresidents.
- Authorizations for the purchase of domestic bonds with (remaining) maturities of more than two years are normally granted.

November

- Authorizations for the purchase of domestic bonds with (remaining) maturities of more than one year are normally granted.

1981

March

- The purchase of any domestic bonds and money market paper by nonresidents is normally approved.

August

- Removal of the existing authorization restrictions on the purchase of domestic bonds and money market paper by nonresidents.

1984

December

- Act governing the abolition of coupon tax on interest received by nonresidents from domestic bonds, with retroactive effect from August 1984.

Source: Deutsche Bundesbank.

India

India's experience with globalization over the past decade has been somewhat different from that of most other G-20 countries, both in terms of the approach taken and the associated benefits, concerns, and policy challenges. Recognizing the various benefits and costs of globalization—and taking into account lessons from other countries that embraced globalization much sooner—Indian authorities have adapted the content, sequence, and timing of international integration policies to minimize potential shocks and maximize benefits. This cautious approach has been guided by the perceived tradeoffs between risks and returns and by the authorities' low tolerance for risk. But since the East Asian financial crisis that started in 1997, there have been major shifts in international views on globalization—and today mainstream views closely resemble India's approach.

India's globalization policies

Although India's interface with the global economy started earlier, deeper globalization was triggered by the country's external debt crisis in 1991. Though Indian policymakers were not enthusiastic about economic openness (Desai 1999), the crisis induced a more systematic approach to globalization policy. These efforts involved:

- Removing restrictions on current payments and transfers to make the current account convertible, in accordance with article 8 of the International Monetary Fund (IMF) articles of agreement.
- Liberalizing underlying current account transactions—particularly dismantling tariff and nontariff trade barriers.
- Switching to a market-determined exchange rate—which, along with comfortable foreign exchange reserves, provided key "self-insurance" against globalization shocks.
- Prudently managing the capital account to ensure a shift in capital inflows in favor of longer-maturity debt and nondebt flows.
- Adopting a cautious, calibrated approach to capital account convertibility.

Moreover, measures ensuring a sound macroeconomic environment, a strong and resilient financial system, and above all an increased market orientation of the domestic economy greatly influenced the course of globalization in terms of content, timing, and sequencing.

Liberalization of quantitative trade restrictions

Prior to the 1990s India had one of the world's most complicated and protected trade regimes, with imports regulated by both quantitative restrictions and high tariffs. India started dismantling quantitative restrictions in the 1990s as a part of the reform process. Of more than 10,000 tariff lines on imports, 6,161 were freed in April 1996. Import restrictions on 488 tariff lines were removed in 1996–97, 391 in 1997–98, 894 in 1998–99, and 714 in 1999–2000.

As part of World Trade Organization (WTO) commitments, the required dismantling of restrictions maintained on balance of payments grounds was completed in March 2001 for the remaining 715 items. As a result action has been completed on removing restrictions on all tariff lines (2,714 items) notified to the WTO under balance of payments cover. Quantitative restrictions, however, are still maintained on about 5 percent of tariff lines (538 items), as permissible under articles XX and XXI of the General Agreement on Tariffs and Trade on grounds of health, safety, and moral conduct. With the progressive liberalization of quantitative restrictions on imports, the tariff lines freed for import increased from 61 percent in April 1996 to 95 percent in April 2001.

Rationalization of the tariff structure

During the 1980s there was a sharp increase in tariff rates, with the average import-weighted duty rising from 38 percent in 1980 to 87 percent in 1990. At the start of reforms, the peak effective tariff was 355 percent.

India embarked on tariff rationalization in the early 1990s. Significant policy initiatives were also introduced for the tariffication of non-tariff measures. Between 1990–91 and 1998–99 the peak tariff dropped from 355 percent to 45 percent. During 2001–02 a 10 percent surcharge on customs duties was abolished, lowering the peak tariff from 38.5 percent to 35 percent. The budget for 2002–03 further lowered the peak tariff, to 30 percent.

The government plans to lower the peak tariff to 20 percent in 2003–04, and an inter-ministerial working group has been set up to recommend modalities in this regard. Once the group's report has been finalized and its recommendations examined, it is expected that by 2004–05 there will be only two basic rates for customs duties: 10 percent for raw materials, intermediates, and components, and 20 percent for final products. Existing rates will be adjusted and subsumed in these two basic rates, with some exceptions for WTO bindings and some higher tariffs for agricultural products.

Procedures have also been rationalized and simplified, including pruning of notifications, elimination of many end-use exemptions, unification of rates for similar items, and merging of basic and auxiliary rates. In addition, in 2001–02 the number of rates with ad valorem rates was reduced to four categories of 5, 15, 25, and 35 percent.

Current account convertibility

The removal of restrictions on payments and transfers for current account transactions gathered momentum after the restoration of normalcy on the external payments front following the 1991 crisis, leading to the formal acceptance of article 8 of the IMF articles of agreement in 1994. With a convertible current account, authorized dealers were allowed to provide foreign exchange for current payments and transfers up to specified limits without notifying the Reserve Bank of India. Since then those limits have been raised considerably. As a result all genuine foreign exchange needs for current account transactions are met directly by authorized dealers.

One of the main concerns about making the current account convertible—that a surge in demand for current payments would widen the current account deficit to unsustainable levels—was not borne out, and the current account position has stayed within sustainable levels in subsequent years. Another apprehension—that with an open current account and regulated capital account, hidden capital flight might increase in the guise of current transactions—also did not turn out be a major cause for concern. In fact, net capital flows were large enough to meet the financing gaps in the current account, leading to comfortable reserve buildup.

Restructuring of the capital account

Until the early 1980s there was little need for a comprehensive policy framework to attract alternative forms of foreign capital, because foreign exchange made available through external assistance—with a large grant component—provided nearly 80 percent of financing requirements (Rangarajan 1996). High levels of official imports were sustained mainly by external aid.

External commercial borrowing. During the 1980s India increased its reliance on commercial loans because external assistance fell short of growing financing needs. Under the policy for external commercial borrowing, initially a very cautious approach was pursued by allowing a few select banks, financial institutions, public entities, and private corporations to raise commercial capital in the international market in the form of loans, bonds, and euronotes. Interest rates and maturities for commercial loans improved during the 1980s.

Despite significant diversification in capital inflows in the 1990s, annual approvals for external commercial borrowing were raised only gradually. Borrowing policies continue to emphasize low borrowing costs, long maturity profiles, and end-use restrictions (with proceeds to be used for imports of capital goods and services and to finance project-related rupee expenditures).

Foreign direct investment and portfolio flows. The need to supplement debt capital with nondebt capital—with a clear prioritization in favor of the latter—characterized government policy for foreign direct and portfolio investment in the post-reform 1990s. In 1993 the High-level Committee on Balance of Payments recommended shifting the composition of capital inflows in favor of nondebt flows and strictly regulating short-term debt flows, as well as discouraging volatile foreign deposits and dissociating the government from the intermediation of aid flows. This major shift in policy was reflected in the liberalization of norms for foreign direct and portfolio investment in the 1990s.

Even in the immediate post-independence period, the government tried to attract private foreign investment by promising equal treatment of national and foreign firms in industrial policy, reasonable facilities for profit remittances consistent with the foreign exchange position, and fair compensation for nationalization of assets. Despite subsequent changes in policies toward private foreign investment, these three promises have always been kept. But by the early 1970s the government wanted to attract foreign investment on its own terms. Accordingly, the Foreign Exchange Regulation Act of 1973 required firms to either dilute their foreign equity holdings to 40 percent or seek fresh permission from the Reserve Bank of India.

Foreign investment was essentially viewed as a vehicle for transferring technology not available domestically and as a means for promoting export-oriented production. Good export performance was seen as a way to raise equity participation above 40 percent. Licensing was the preferred mode for technology acquisition, and in cases where unbundling of technology from equity participation proved difficult, equity participation was allowed.

The restrictive policy environment enunciated in the Foreign Exchange Regulation Act of 1973 continued during the 1980s, with occasional liberalization for certain categories of investments. Toward the late 1970s it was realized that a number of oil-exporting countries had accumulated large surplus funds—but, due to the emphasis on appropriate technology, they could not invest in India. In 1980 such countries were permitted to invest up to 40 percent in specified industries in India without any transfer of technology. In addition, a "fast channel" was introduced in 1988 to expedite clearance of foreign direct investment (FDI) proposals from major investing countries.

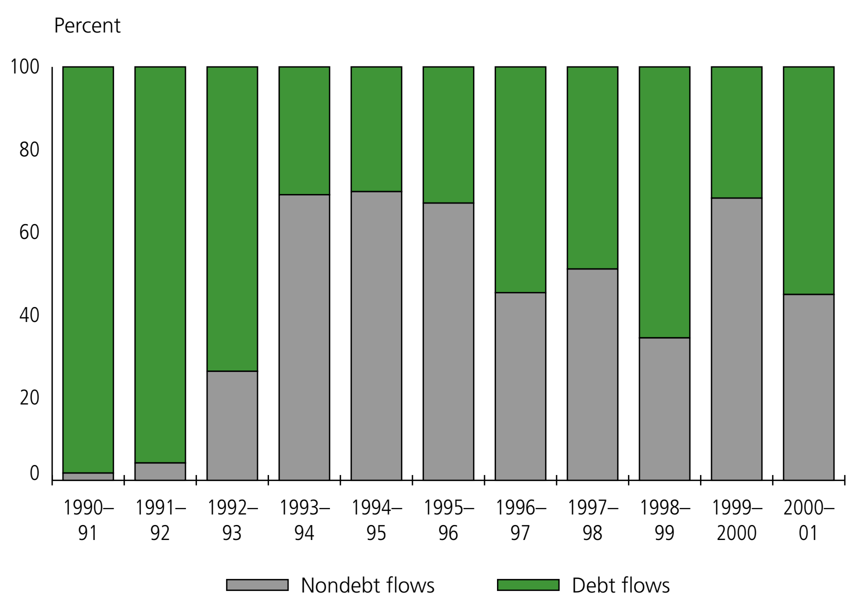
In the 1990s major liberalization measures were introduced as a part of overall structural reforms. Restrictions were lifted on companies formerly covered by the Foreign Exchange Regulation Act, allowing them to borrow money and accept deposits from persons resident in India, to carry out trading activities (other than agriculture and plantation), to acquire, hold, transfer, sell, lease, and gift any movable property in India, and to allow the use of trademarks by any person or company.

The liberalization process started with automatic approval of up to 51 percent for investment in select areas. Subsequently, the areas covered by automatic approval and the limits on investment were raised, culminating in permission for 100 percent participation in certain areas (particularly oil refining, telecommunications, and manufacturing activities in special economic zones) and bringing FDI in all but a few negative list items under the automatic route. The requirement of balancing dividend payments with export earnings, which was earlier limited to a short list of 22 consumer goods, was completely withdrawn. The limit of 1,500 rupees crores for FDI in projects relating to electricity generation, transmission, and distribution was removed. FDI in nonbank financial activities and insurance was also permitted.

Restrictions on portfolio investment through purchase of both traded primary and secondary market Indian securities were also liberalized. As opposed to the earlier restriction permitting nonresident Indians and overseas corporate bodies to acquire up to 1 percent (individually) and up to 5 percent (together) of the paid-up capital of Indian companies, the ceiling was initially raised to 24 percent, with investment by foreign institutional investors allowed in 1992. Subsequently the limit was raised gradually—and finally, in 2001, foreign institutional investors investment was permitted up to the sectoral caps and statutory ceilings prescribed for FDI in different sectors, provided the general body of the respective firms makes a decision to that effect.

Portfolio investment by foreign institutional investors through investment in general despository receipts (GDRs), American despository receipts (ADRs), and foreign currency convertible bonds (FCCBs) floated by Indian companies in international markets was also permitted, and over time the initial restrictions on the end use of GDR, ADR, and FCCB proceeds were removed. Foreign investment responded favorably to the liberalized policy environment and to the general improvement in macroeconomic conditions brought about by growth-supporting structural reforms. By 1993–94 FDI and portfolio flows taken together emerged as the most important source of external finance, and net nondebt flows exceeded debt flows in the form of deposits by nonresident Indians, external commercial loans, and external assistance (figure 1). Foreign investment has remained the most important form of external financing for India.

Figure 1. Net debt and nondebt flows to India, 1990–2001



Approach to capital account convertibility. India considers the liberalization of its capital account a process, not a single event. In its gradual and cautious approach to capital account convertibility, initial reform measures were directed at current account convertibility, leading to acceptance of IMF article 4 by August 1994. For operationalizing capital account convertibility in India, a clear distinction is made between inflows and outflows, with asymmetrical treatment of inflows (less restricted), outflows associated with inflows (free), and other outflows (more restricted). Different restrictions are also applied to residents relative to nonresidents and to individuals relative to corporations and financial institutions. A combination of direct and market-based instruments of control is used, meeting the requirements of a prudent approach to management of the capital account. The policy of ensuring a well-diversified capital account with a rising share of nondebt liabilities and low percentage of short-term debt in total debt liabilities is amply reflected in India's policies for FDI, portfolio investment, and external commercial borrowing.

The Committee on Capital Account Convertibility (chairman: S.S. Tarapore), which submitted its report in 1997, highlighted the benefits of a more open capital account but at the same time cautioned that capital account convertibility could put tremendous pressure on the financial system. To ensure a stable transition, the report recommended certain signposts and preconditions. Three crucial ones relate to fiscal consolidation, mandated inflation targets, and a strengthened financial system. The second phase of financial sector reforms and the ongoing measures for fiscal consolidation could enable India to meet the initial conditions for capital account convertability.

International developments—particularly initiatives to strengthen the international financial architecture for dealing with problems arising in the capital account of a country's balance of payments—will also influence the timing and sequencing of capital account convertibility in India. In the aftermath of the East Asian crisis, India's approach to capital account convertibility has been firmly vindicated. The vastly altered and liberalized policy environment for the external sector is reflected in the Foreign Exchange Management Act of 1999, which replaced the Foreign Exchange Regulation Act 1973. The new act sets out as its objective "facilitating external trade and payment" and "promoting the orderly development and maintenance of foreign exchange markets in India".

Financial sector reforms—setting the pace of globalization

At the policy level, a strong and resilient domestic financial system has always been viewed as a precondition for greater cross-border integration of the economy. Reforms in the financial sector have generally comprised:

- Deregulation of interest rates.
- Reductions in statutory preemptions.
- Stronger regulatory and supervisory systems.
- Implementation of international norms on capital adequacy, asset classification, income recognition, and provisioning.
- Promotion of competition by allowing private and foreign banks to operate alongside public banks.
- Improvements in payments and settlement systems.
- Development of the market for government securities.
- Market borrowing at market-related interest rates, while doing away with automatic monetization of fiscal deficits. Specific measures for improving credit delivery and strengthening loan recovery.

Ongoing initiatives include plans to introduce an asset reconstruction company, corporate debt restructuring framework, and legal reforms to support both (as well as debt recovery) implementation of prompt corrective action, promotion of FDI in the banking sector, disinvestment in public banks, creation of a credit information bureau, and switching to a real time gross settlement system. Internal surveillance of the financial system has also been strengthened significantly, using a combination of information collected through onsite and offsite supervision and market information.

Thus in the Indian brand of globalization, policy initiatives were prioritized in favor of liberalization of current account transactions, leading to significant liberalization of trade restrictions in the reform decade and meeting the requirements of an open trade regime at the global level. A prudent approach to management of the capital account ensured external debt sustainability, a diversified capital account, and a shift in net inflows in favor of non-debt and longer-maturity foreign capital. An appropriate exchange rate regime meeting the requirements of the Indian brand of globalization and a comfortable reserve level in terms of all known measures of reserve adequacy have helped enhance India's ability to deal with unanticipated shocks induced by globalization. The prudently managed capital account has also helped contain the transmission of pure contagion from global financial markets. In fact, external sector performance during the reform decade imparted considerable strength and resilience to the growth and development of the Indian economy.

Impact of globalization on the Indian economy

Measuring the impact of globalization is as difficult as measuring globalization itself. In India, where internal liberalization efforts were implemented along with measures for enhancing the country's openness to the global economy, it is even more difficult to assess the impact of globalization because critical macroeconomic variables would have responded to both sets of measures, making it difficult to disentangle the joint effect. At times, certain structural changes quite unrelated to the policy measures directed at internal reforms and stronger globalization may also have influenced macroeconomic variables.

Thus one can only analyze the behavior of macroeconomic variables generally perceived to respond to globalization. In a sense one can only draw inferences from the behavior of each relevant variable during the globalization process, without attempting to attribute it entirely to globalization. Following such an approach, this section assesses the behavior of the overall economy in the context of globalization.

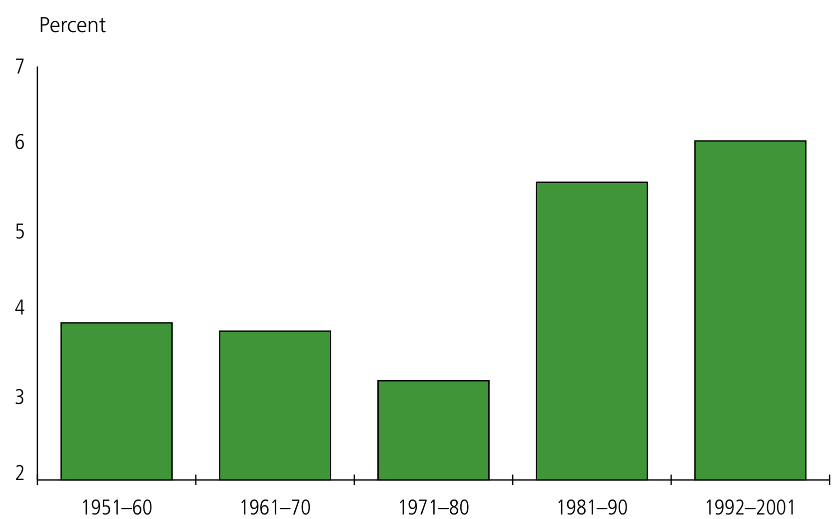
Growth

In examining the growth-inducing effects of globalization, it is important to assess whether the average actual growth during the reform years was higher than the growth recorded during the previous decades of planned development. Average GDP growth of about 6.1 percent during the reform years (1992–93 to 2000–01) was somewhat higher than the growth exhibited during the immediately preceding decade (5.6 percent) and significantly higher than in all other previous decades (figure 2).

The average 6.1 percent growth during the reform years, however, hides the real performance on growth due to the large degree of dispersion around the average. There was a three-year phase during the reform years (1994–97) when average growth was about 7.5 percent. There were also years of lower growth, as in 2000–01 at 4.0 percent. This rate of growth, however, when assessed in the context of the global slowdown, was still one of the highest in the world.

A major indicator to examine the impact of globalization is the extent of synchronization of business cycles. In India, despite growing cross-border integration in trade and services, there is little evidence of major synchronization of growth, even though in recent years global business cycles—particularly the strong slowdown in economic activity that started in mid-2000—have contributed to the weaker activity in India (figure 3).

Figure 2. Real average annual GDP growth in India, 1951–2001



Note: 1991–92 was the crisis year.

Saving, investment, and the degree of financial openness in India

A high correlation between saving and investment is an indication of a lower degree of dependence on external capital for growth. The well-known Feldstein-Horioka puzzle shows that the degree of capital mobility may not be very high across countries. In India, because of the conservative approach to the current account deficit (as a percentage of GDP), the saving-investment gap has generally remained very modest.

In the 1990s, however, net capital inflows generally exceeded the saving-investment gap, leading to large accretion to foreign exchange reserves. (Reserve accretion since the early 1990s has been in excess of $54 billion.) Unless the degree of productive absorption of foreign capital in the country increases further and exports (of both goods and services) grow even faster to raise the current account deficit from its present level of about 2 percent of GDP, the benefits from deeper financial integration with the global economy are likely to be rather limited.

In other words, achievements in trade integration should determine the degree of financial integration. In the past decade, however, net capital flows were much in excess of net current account flows, suggesting the presence of significant financial integration relative to integration on the current account. Restrictions on residents in terms of cross-border financial transactions have not constrained the country from achieving the type and level of financial integration required to harness the benefits of trade flows by running a sustainable current account deficit and building appropriate self-insurance in the form of adequate foreign exchange reserves.

Degree of trade openness

Degree of trade openness is an important indicator for analyzing globalization's impact since it explains the role of exports and imports in the growth process. It also suggests the degree of sensitivity of national GDP to fluctuations in net exports in response to both global business cycle developments and changes in global trading regimes.

The trade openness of an economy has two distinct but often interrelated dimensions: ex ante openness and ex post openness. Ex ante trade openness relates to the restrictive nature of policy toward exports and imports. The levels of tariff and nontariff measures applied by a country on cross-border trade flows are the most important indicators of ex ante trade openness. Ex post trade openness, on the other hand, refers to actual levels of imports and exports in relation to domestic economic activities. At any point in time high (low) levels of ex ante openness may coexist with low (high) levels of ex post openness.

A major problem in the analysis of trade openness is that openness is neither directly observable nor strictly defined. The simplest measures of trade orientation, therefore, use the share of trade flows in GDP. This ratio shows a decline in India's trade openness in most of the 1980s, then a rising trend from 1987–88 through 2000–01 (figure 4). Given the predominant share of services in GDP, it may be more appropriate to consider trade in both goods and services as a percentage of GDP. This indicator suggests that India's trade openness has increased almost unabatedly since 1987–88.

Over the past five decades Indian export performance (in terms of U.S. dollar value) almost mirrored global performance, even though the degree of openness exhibited major improvement only in the 1990s and India's market share in global exports generally declined until the early 1990s. (It fell from around 2 percent in the 1950s to about 0.5 percent in early 1990s, then recently recovered to about 0.7 percent.)

Figure 3. GDP growth in India and worldwide, 1992–2001

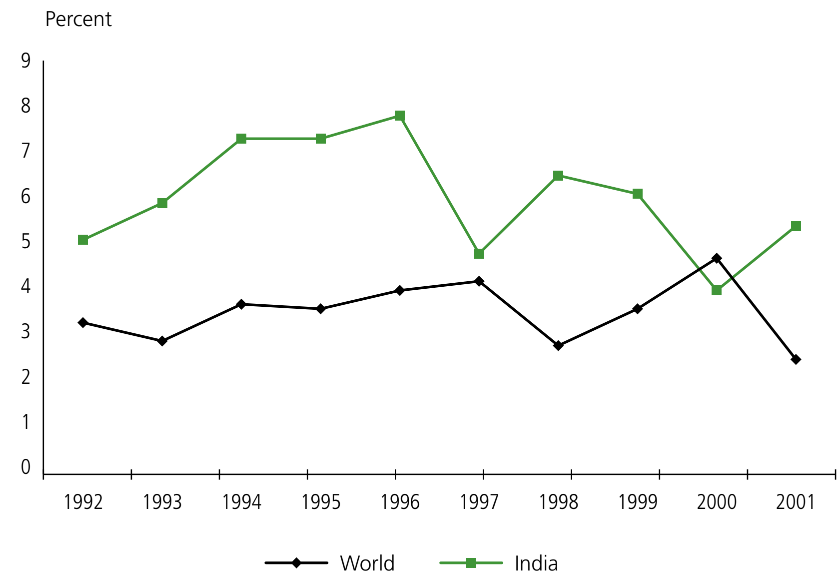
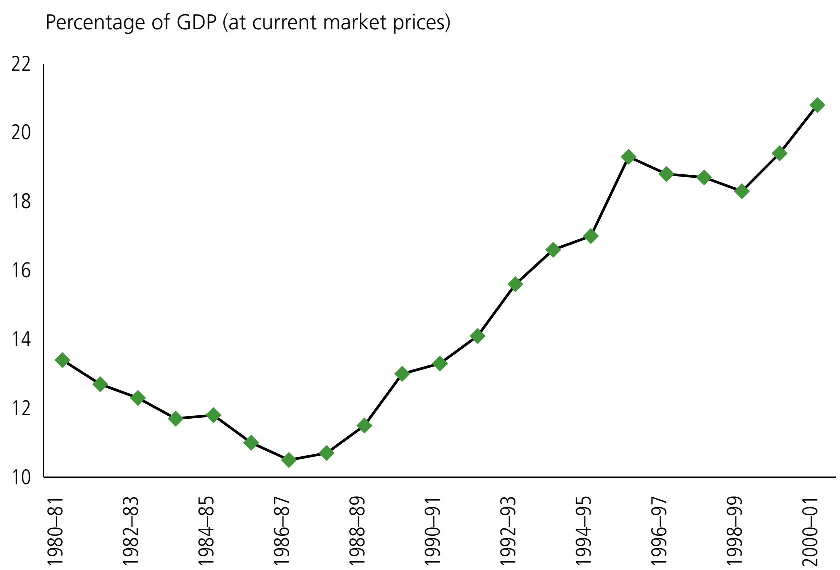


Figure 4. Merchandise trade in India, 1980–2001



Terms of trade

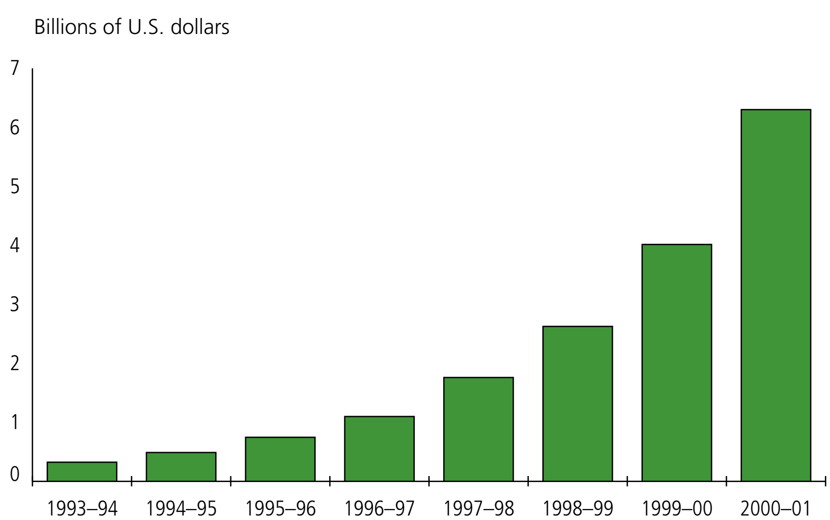
Deterioration in terms of trade has been a major concern among many developing countries because it can weaken the benefits of participating in a globalized system of trade and distort the resource transfer system. Between 1970 and 2000 India's gross and net barter terms of trade exhibited a stable pattern with low periodic dispersion, indicating that deterioration in terms of trade has not been a major concern for India during the phase of globalization. The income terms of trade—representing the capacity to import—generally improved during the 1990s, suggesting larger opportunities offered by greater trade integration.

India's software boom—the most visible benefit of globalization

India's strong performance on the software front was largely facilitated by the globalization process. In the second half of the 1990s software exports exhibited compound average growth of 62.3 percent, as against 46.8 percent growth in domestic market sales. In U.S. dollar terms software exports registered average annual growth of 46.1 percent during the entire 1990s. This rate of growth has been unprecedented both in terms of overall growth and growth in exports.

In 2000–01 software exports hit a peak of $6.3 billion (figure 5). A recent survey of 200 software companies found that external markets accounted for 82.5 percent of their revenue (with the United States alone accounting for more than 60 percent). Thus software is expected to enhance the benefits of globalization for India. Still there is a long-run concern of a possible "Dutch disease" effect, with fast growth in one export item weakening the prospects of other tradable sectors—by not only switching resources from slow-growing exports to the fast-growing sector but also by exerting pressure on the exchange rate to appreciate, which would weaken the prospects of slow-growing exports without hurting the fast-growing sector.

Figure 5. Software exports from India, 1993–2001



Nonresident Indians as a force of globalization

Cross-border movement of labor has generally been limited by the very restrictive immigration policies of industrial countries. Despite the restrictive international regime for labor mobility, nonresident Indians—both skilled and unskilled—have taken advantage of the limited scope for migration and with their committed work in foreign countries provided a strong channel of connectivity between the Indian economy and the global economy. The three main flows through which India has benefited from this channel of globalization are private remittances, deposits by nonresident Indians in Indian banks (both in Indian rupees and in foreign currencies), and FDI investment by nonresident Indians. (Portfolio investment by nonresident Indians has generally been quite meager.)

Private remittances grew by more than 60 percent a year in the 1990s, from $2 billion in 1990–91 to $12.8 billion in 2000–01, matching the performance of software exports during this period (figure 6). These flows do not increase the country's external liabilities and so provide strength to India's balance of payments. Deposits and FDI from nonresident Indians, however, have not shown any major spurt, though they remain important and somewhat stable forms of foreign capital for India.

Globalization through trade in services

Given that services account for more than half of the GDP of India and that services also dominate the economic activity of India's main trading partners, exports of nonfactor services will have to assume greater importance over time in India. Trade in services, though growing, still lags significantly behind merchandise exports. Exports of services as a percentage of merchandise exports, however, showed a significant increase in the second half of the 1990s. At 42 percent in 2000–01, this share is one of the highest in the world, particularly in relation to about 10–20 percent for China and the Far East, Germany, Japan, Mexico, Russia, South Africa, and even about 26 percent for the United Kingdom and the United States (Raipuria 2001).

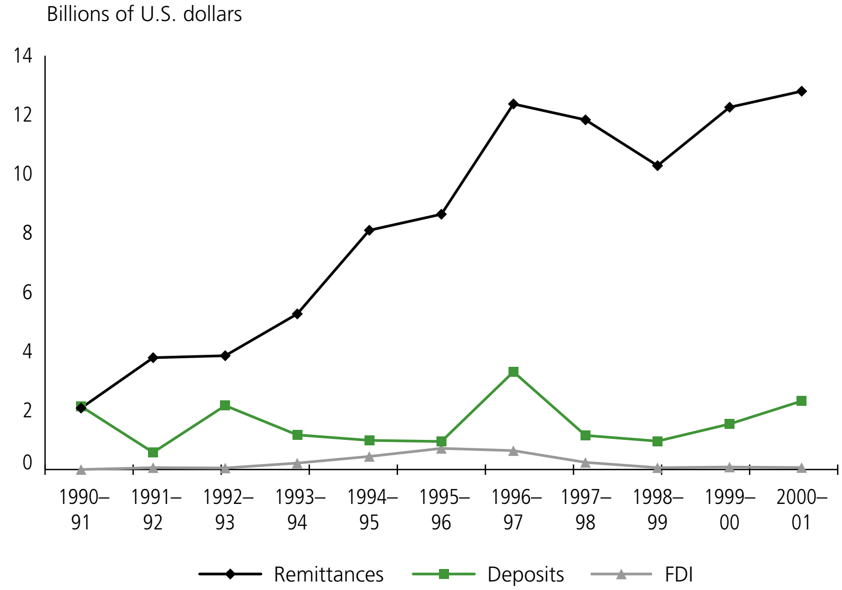
This suggests that even though India's degree of trade integration with the global economy is not very high, services exports seem to be of much greater importance in recent years in relation to the world average. Unlike China, the Republic of Korea, Mexico, Poland, Russia, South Africa, and Thailand, where tourism and transportation services account for the major share of services exports, in India other services account for the largest share. This makes India's pattern of services exports akin to that in advanced countries like Germany, Japan, the United Kingdom, and the United States and some developing countries like Brazil, Malaysia, and Turkey (Raipuria 2001).

The impact of FDI on growth, technology, and employment

It is difficult to assess the direct contribution of FDI flows to the growth process. Information collected from annual surveys of select foreign-controlled rupee companies however, offer some pointers about the contribution of FDI firms to the growth process in India. It is generally believed that FDI serves as a vehicle for promoting export-led growth. But these firms export only about 10 percent of their domestic sales, and their export intensity increased only modestly in the 1990s. It appears that lure of India's large domestic market continues to be one of the primary factors causing FDI flows.

Positive externalities associated with FDI in the form of technology transfers are another factor that could contribute to growth. In developing countries technology transfers must accompany investment in domestic research and development (R&D) to enhance adaptation and absorption. The relationship between technology imports (comprising imports of capital goods and payments for royalty and technical know-how fees) and domestic technology efforts in terms of R&D expenditure did not exhibit any complementarity. Rather, foreign exchange spent on technology imports as a percentage of domestic spending on R&D increased significantly in the 1990s.

Figure 6. Contributions by nonresident Indians, 1990–2001



FDI firms outperformed overall growth in industrial production in the 1990s. Higher relative growth in output in itself, however, does not explain the linkage between capital flows and growth—though it suggests the presence of more productive sectors in India that FDI firms could explore.

FDI firms are often believed to use transfer pricing mechanisms to create a gap between the visible and invisible patterns of resource transfers. Use of imported inputs in relation to total inputs could broadly indicate whether FDI firms are using transfer pricing mechanisms by relying on large-scale, artificially inflated imported inputs. But the share of imported raw materials in total raw materials used by FDI firms has more or less hovered around just 20 percent. If one takes a view only on the basis of this indicator, the transfer pricing effect does not seem to be very strong for India.

Signs of inflation convergence due to globalization?

Free cross-border movement of goods is expected to lead to a certain degree of convergence in commodity prices around the world, though transportation costs and nontransparent barriers to trade could cause some price differences to persist. India's inflation environment has generally remained quite benign in the post reform period, both in relation to the inflation levels of developing countries and in terms of the stability of general prices.

The first half of the 1990s was characterized by double-digit inflation (based on wholesale prices)—with the sole exception being 1993–94, when the inflation rate was 8.4 percent. During 1990–91, 1991–92, and 1992–93 the general price level came under severe pressure following the balance of payments crisis. During these years inflation was 10.3 percent, 13.7 percent, and 10.1 percent. In more recent years annual inflation has fallen, to 4.9 percent in March 2001 and to 1.4 percent in March 2002.

The recent downward trend in the inflation rate reflects a number of structural and policy factors that have undergone major change following economic and financial liberalization. The period also coincided with a global trend of low inflation. While agricultural shocks still play a relatively large role in the inflation environment, the large cushion provided by a record buffer stock of food grains and the wide reach of the public distribution program have helped minimize the impact of such adverse supply shocks on food prices and the general inflation rate.

As far as manufacturing prices are concerned, the inflation rate has come under the influence of competition, deregulation of price controls in several core sectors, and the absence of adequate demand due to the industrial slowdown. There has been evidence that some manufacturing segments recorded higher productivity growth in the post-1991 period. The manufacturing sector has been also going through restructuring and experiencing higher price competition. This seems to be pushing down the markup rate, especially in industries that import. Another important factor for prices in manufacturing relates to the fall in world manufacturing prices.

Convergence of the monetary policy stance

In the context of the synchronization of business cycles across the globe in recent years, a perception is gaining that the monetary policy stance of central banks may also become synchronized. Thus globalization could lead to some loss of monetary policy independence. With the introduction of financial sector reforms in India, the monetary policy framework tended to rely more heavily on the use of indirect instruments rather than direct instruments like reserve requirements. As a result the importance of the Bank Rate—which can influence the cost and availability of credit in the economy and send appropriate signals on the stance of policy—has gained prominence in the recent period.

The Bank Rate, which was a discount rate in the earlier period, remained nonoperational for quite some time due to the absence of a developed bill market and the prevalence of directed lending. With financial sector reforms, the Bank Rate was activated and made essentially a signaling rate in April 1997, linking it to rates at which accommodation is provided by the Reserve Bank of India. In the recent period, the behavior of the Bank Rate seems to have followed the Fed cycle somewhat, mostly in terms of direction rather than magnitude. The interest rate stance, however, continues to be influenced primarily by internal considerations, even though external developments have been assigned greater importance than in the past due to the growing (though modest) cross-border integration of the economy.

Interest rate parity

In the context of globalization of finance, it is expected that the risk-adjusted return on financial assets in different countries will tend to converge. One common approach to examining this aspect is to plot the behavior of interest rate differentials against the corresponding forward premiums. The argument being that, an instrument in a particular currency fetching a lower interest rate must fetch a premium to compensate investors for the higher interest rate they could have received by holding the instrument in another currency. When investors are risk averse, expected returns on different instruments would depend not only on the parity conditions but also on the risk premiums. In the presence of time-varying risk premiums, the complexities related to identifying sources of risk and measuring risk greatly complicate the empirical testing of parity conditions.

When interest rate differentials based on monthly average call money rates in both Indian and U.S. markets are considered, one-month swap premiums seem to exhibit a relatively stronger linkage with the interest rate differentials. Despite the remaining restrictions on capital account transactions, the sensitivity of domestic financial markets to interest rate differentials seems to have increased during the reform years.

Exchange rate behavior

In a globalized system of trade and finance the different channels of contagion become stronger and, as a result, the exchange rates of developing countries with sound economic fundamentals may at times exhibit significant volatility. Recognizing this aspect, the Reserve Bank of India (RBI) closely monitors developments in financial markets at home and abroad in its conduct of exchange rate policy and from time to time takes monetary and administrative actions considered necessary. It was explicitly clarified in the bank's Annual Monetary Policy statement of 1998 that "RBI will not hesitate to use its reserves, when warranted, to meet sharp day-to-day supply-demand imbalances in the market...It will ensure that lumpy and uneven demand, particularly for oil imports and debt servicing obligations of the Government, does not cause any disturbance in the orderly functioning of the foreign exchange market". Keeping in view the role of destabilizing expectations, the RBI reiterated in the Mid-term Review of its Monetary Policy in October 2000 that "in the very short-run, expectations about the likely behavior of a currency next day or over a week or fortnight can play a major role in determining its movement against foreign currencies, particularly the U.S. dollar. Given the bandwagon effect of any adverse movements, and the herd behavior of market participants, expectations can often become self-fulfilling. This is particularly true of thin developing country markets, where net volumes are relatively small. The day-to-day movement in currency markets is further complicated by volatility in private capital flows, which are highly sensitive to short-term domestic and international developments as well as future expectations".

The adverse implications of disorderly exchange market conditions for the real sector of the economy also warrant close monitoring of the exchange rate. In view of the above factors, as stated by the RBI in its Annual Monetary Policy Statement of April 2002, "India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. Despite several unexpected external and domestic developments, India's external situation continues to remain highly unsatisfactory. RBI will continue to follow the same approach of watchfulness, caution and flexibility while dealing with the forex market. It is a matter of satisfaction that the recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India".

The exchange rate of the Indian rupee generally avoided contagion, even though market corrections for perceived misalignments often came alongside major adverse international developments. For example, the real appreciation of more than 10 percent (both trade and export based and in relation to the March 1993 level, when the exchange rate of the rupee became market determined) generally preceded market corrections. But some of these corrections coincided with adverse international developments like the East Asian crisis in the second half of 1997, the Russian crisis and the fear of Chinese devaluation in 1998, and the September 11, 2001 terrorist attacks on the United States. The Indian rupee, however, was one of the most stable currencies among emerging markets in the past decade, with no major accumulation of real appreciation at any point. Perceived misalignments have been corrected in an orderly fashion.

Poverty in the post-reform period

India's poverty levels fell considerably during the reform years. While the population below the poverty line declined by 8.5 percentage points during 1983–93, during the reform period (1993–94 to 1999–2000) it declined by 9.9 percentage points. Unlike in the pre-reform period, when the absolute number of poor people remained almost unchanged at around 320 million, during the reform years the number fell, to 260 million in 1999–2000. There are difficulties in comparing poverty estimates across time in India in the context of analyzing the impact of globalization because of the high degree of sensitivity of the poverty measures to the behavior of monsoon—arising from the concentration of poor people in rural areas (accounting for about 70 percent of the total) and the excessive dependence of the rural masses on agriculture. Due to the differences in the methodology for measuring the incidence of poverty, as observed in the *India Development Report 2002* "...even when one does not accept the faster decline (in poverty) over the 1990s, one can conclude that the accelerated reforms and deregulation and liberalization of the 1990s have not adversely affected the trend of decline in poverty".

Income inequality in the reform period

Estimated Gini coefficients for 1973–97 show that the pattern of inequality did not change much between the pre-reform period and the post-reform period (Oommen 2000). In the context of the Kuznets inverted "U" pattern relationship between inequality and growth, it has been argued that tolerating some short-run higher inequality in exchange for higher growth may lead to higher growth and lower inequality in the long run. The debatable issue here is, if globalization can lead to both higher growth and lower poverty, should higher inequality be tolerated in the absence of any established development alternative that can achieve all three simultaneously?

Regional disparities in growth

Growth disparity across different states of India has been a major concern for policymakers during the entire period of post-independence development strategy. The pattern of per capita state domestic product suggests that regional disparities did not deteriorate during the reform decade. If one uses 1980–81 as the benchmark year, there are only four states—Maharastra, Punjab, Gujarat, and Hariyana—where per capita state domestic product (at 1980–81 prices) was higher than per capita GDP for all of India. The trend remained more or less similar in 1990–91. With the advent of the reform program in the early 1990s, the only state that joined the other four was Tamil Nadu. At the other end of the spectrum, the states at the bottom in terms of real per capita state domestic product continued to be Orissa and Bihar. This suggests that regional disparities did not widen in the post-reform period.

Lessons and policy challenges

In India the globalization process has been an important part of the overall process of economic reform—even though, given the relatively small share of external transactions in overall economic activity, internal reforms have largely shaped the evolution of the macroeconomy during the past decade of economic reforms. India exhibited one of the highest growth rates in the decade of economic reforms, both in relation to other economies and to its own pre-reform performance. Despite having a market-determined exchange rate, its exchange rate remained the least volatile of all flexible exchange rate regimes. It avoided the contagion from a series of financial crises that engulfed emerging markets in the 1990s.

The financial system also acquired considerable strength and resilience during this period, helping the authorities avoid a large-scale systemic crisis. A well-managed capital account helped ensure sustainability of the external account and limited exposure to identifiable vulnerabilities. In addition, high foreign exchange reserves imparted significant confidence to the market. Low and stable inflation in the second half of the 1990s provided an atmosphere conducive to investment, growth, and social advancement. Most important, poverty fell considerably during the decade.

Globalization, however, also posed a number of challenges. In the context of the signs of increasing (though still modest) synchronization of business cycles, the earlier high insulation of national output and employment from global developments seems to be declining. Given the possible asymmetric effects of global business cycle fluctuations during alternating phases of boom and bust, stabilizing macroeconomic policies to counter the large amplitude of the business cycle has emerged as a major policy concern. The complexity of this challenge appears even more severe now due to the increasing degree of external impact on domestic activity—over which the national authorities have little control. Like many other G-20 members, the usual concern has also been the possible ineffectiveness of national policies in a globalized system, leading to a search for measures that could help the authorities regain policy independence.

Globalization is generally believed to yield convergence in prices, interest rates, and tax rates across countries because differences (adjusted for country-specific factors and risks) in these critical variables are expected to trigger appropriate movements of goods, capital, and income until the rates are equalized. Though complete convergence is a distant possibility due to the limited degree of India's globalization, it is quite possible that national interest rates and tax rates will be less effective now than when the economy was relatively closed. Dealing with the problem of inefficiency in a globalized system of trade and finance has also emerged as an important challenge for the policy authorities.

The policy of avoiding financial crises while attaining the dual goals of higher growth and lower poverty has generally shaped the broad contours of globalization in India. Correspondingly, it has also significantly altered the role of the state in the economic affairs of the country. Growth without trickle-down effects and higher growth at the cost of financial stability are the two major downside risks associated with globalization, and the need to limit India's exposure to such risks has motivated the national authorities to take a cautious, measured approach to globalization. The pace and timing of specific reforms have been guided by the relative probability and intensity of the benefits and costs of any particular measure to the economy as well as the long-run sustainability of the measure, so policy reversals are generally avoided. The Indian approach to globalization seems to indicate that avoiding highly disruptive as well as extreme forms of globalization and tailoring the pace and content to each country's circumstances may be the ideal strategy for globalization in a number of emerging markets.

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Italy

The Italian economy, like those of other European countries, underwent a deep transformation after World War II, turning into a fast-growing industrial economy and setting up a financial system able to allocate abundant household savings[1]. Regulation took different forms and intensities in the specific segments of the financial market. Controls were broad in the banking system and in foreign exchange markets, less pronounced in stock and bond markets.

There are many reasons behind this extensive system of controls, and their economic rationale has changed over time. In the 1960s the priority was channelling financial resources to the fast-growing industrial sector. The 1970s and 1980s, unlike the previous decade, were characterized by a highly unstable international macroeconomic environment, heavily affected by the breakdown of the Bretton Woods system of fixed exchange rates and by the oil shocks of 1973 and 1980. Working with increasing domestic macroeconomic imbalances, the country's regulatory system aimed to partially insulate domestic financial markets from external shocks: gaining some degrees of freedom for monetary policy; preventing exchange rate instability, all the more after joining the European Monetary System in 1979; securing a smooth flow of bank credit to the industrial sector; and guaranteeing the orderly placement of a fast growing public debt.

At the end of the 1980s, as monetary unification gained momentum in Europe, a number of forces led Italian authorities to gradually lift the system of domestic and foreign administrative controls. The main factor behind this process was, first, the need to fully integrate Italy in the single European market and, later on, to satisfy the requirements for adopting the single currency.

At the same time, Italy made an effort to reform and modernize its financial markets, particularly money and bond markets. The drive to improve the efficiency of these markets—making them deeper and more liquid—came from interrelated needs: making Italian markets competitive in a context of growing European and international financial integration; easing the management of the high public debt; and improving the transmission mechanism of monetary policy.

This note describes the broad contours of the process of reform and liberalization of financial markets in Italy in the 1980s and early 1990s. It focuses on reforming the domestic money and bond markets and on dismantling capital controls. One reason for considering these two processes jointly is that they reinforced each other: the abolition of capital controls would have been risky without making Italy's financial system more competitive and attractive to foreign investors. Other important sectors of the financial market will not be included because they require separate analysis: a process of radical reform and liberalization has completely reshaped Italy's banking system, nonbank financial intermediaries, institutional investors, and the stock market (Ciocca 2000). This note, not meant to be exhaustive, sketches the subject in a deliberately simplified way. In addition, the topic is analysed from an institutional point of view, leaving more analytical and policy-related issues in the background.

The reform of the money and financial markets and the liberalization of capital movements

In 1987–90 two major sets of structural reforms in money and financial markets took

TABLE 1

Government debt financing and organisation of financial markets: main reforms

	1981–87	1988	1989	1990	1991	1992	1993	1994
DEBT MANAGEMENT Central bank direct credit							Prohibition of any direct financing	
New debt instruments	First issue of CTE (1982)	First issue of CTOs and of 5- and 7-year CCTs		7-year BTPs	10-year BTPs		30-year BTPs; 1st global bond	
PRIMARY MARKET Central bank purchases	"Divorce" (1981)							
Auctions	Treasury bills: mid month (1981) – Competitive for 3 months (1983) and for 6 months (1984)	Competitive for 12-Month Treasury bills; uniform price for BTPs		Uniform price for CCTs				
Abolition of floor price		3-month Treasury bills	6-, 12-month Treasury bills			BTPs and CCTs		
SECONDARY MARKET Organized spot markets		Screen-based market for government securities (MTS)	Treasury bills traded on MTS					Reform of MTS with introduction of market specialists
Derivatives					Future contracts on BTPs traded on LIFFE	Italian Futures Market; Eurolira futures traded on LIFFE		Options on futures on BTPs traded on MIF
MONEY MARKET Organized market				Screen-based market for interbank deposit (MID)				
Liquidity facility	Credit to banks acting on the Treasury bill primary market (1984)			Mobilization of compulsory reserve deposits				No credit facility to banks acting on Treasury bill primary market
Settlement system			Electronic clearing and settlement	Real-time CAT for securities clearing				

Source: Bank of Italy.

place: those aimed at strengthening the domestic money and financial markets (table 1), and those aimed at eliminating restrictions on capital movements (box 1). The reforms helped the Bank of Italy reduce the volatility of the market demand for treasury securities and improve its ability to conduct monetary policy through the use of indirect, more market-oriented instruments (Passacantando 1996).

BOX 1

Chronology of main changes in exchange control legislation

1976
Exchange control violations directly affecting the external accounts become criminal offenses.

1981
Rationalization of exchange regulation concerning financial transactions. Depenalization of minor exchange violations.

1986
Delegation to government to reform the exchange control system, on the principle that all external commercial and financial transactions are allowed unless explicitly prohibited.

1987
New exchange control law laying down the principle of freedom, but retaining some restrictions, which may be lifted by exchange authorities administratively. Effective October 1, 1988.

Remaining restrictions:
- Foreign exchange monopoly.
- Limits on daily foreign exchange position and on external creditor position in both lire and foreign currency for banks.
- Permanent restrictions on short-term capita1 movements for nonbank residents.

1988
Codified exchange control law incorporating the 1987 decree. Depenalization of exchange violations.

1990
Completion of liberalization: abolition of all remaining restrictions (on money instruments).

Changes in money and bond markets

One proximate factor that stimulated the innovations was the deterioration of market conditions. Until 1987 the continual decline of interest rates eased the financing of the budget deficit. But in the summer of 1987 the expectations of rising interest rates, due to a reversal of the downward trend of inflation, greatly weakened the demand for long-term government securities and led to increasing fears of a subscription crisis. The average maturity of newly issued government securities plummeted in 1987, from three years and three months in April to less than eight months in December. Since then long-term bond issues have not been fully subscribed.

A first set of measures was adopted in the public debt management (see table 1). For a number of years the Treasury relied mainly on short-term bonds and treasury credit certificates (CCTs), which are floating-rate medium-term notes. The CCTs made it possible to lengthen the maturity of public debt at relatively low cost. Risk premia on fixed-rate securities would in fact have been particularly high in a period of high and variable inflation. However, CCTs also had some negative consequences since they made the cost of debt servicing very sensitive to interest rate variations and created a direct, positive link between disposable income and interest rate changes. In the latter part of the 1980s and in the early 1990s the Treasury widened its range of instruments and increased the proportion of longer-term fixed-rate securities. The range of maturities now available, from three months to 30 years, is comparable to that found in the most highly developed financial markets.

Another important set of measures involved the techniques of placing government paper. Between July 1988 and March 1989 the Treasury progressively eliminated floor prices at treasury bill auctions. In August 1992 it also completely liberalized the price at auction of long-term bonds. Competitive bid auctions, in which buyers purchase securities at their bid prices, were extended to all treasury bill issues. In 1988 and 1989 uniform price auctions were adopted for long-term bonds. The extension of auction systems to all issues—and the design of the most appropriate system for each segment of the market—improved the trade off between the cost of borrowing and the need to ensure the availability of funds (Buttiglione and Prati 1991; Buttiglione and Drudi 1994).

A third set of reforms radically reshaped the secondary market for government paper. A well-developed secondary market with operators that ensure continuous trading indirectly spurs demand on the primary market for two reasons. It increases the liquidity of public debt instruments, and it increases the information content of interest rates. A screen-based secondary market for government securities was launched in May 1988. Turnover on this market reached 1.3 percent of GDP in 1993. In the early 1990s derivative markets were introduced.

A fourth set of measures affected the money market and the settlement system. Improvements in securities trading required parallel developments in the procedures adopted by operators to adjust their liquidity positions and settle the underlying obligations. Market participants need smooth clearing and settlement systems to minimize transaction costs and counterparty risk (Angelini and Passacantando 1993). The key reforms in this area were a computerized clearing and settlement system in 1989, a screen-based market for interbank deposits in 1990, which also experienced a rapid growth of turnover, and the reform of the compulsory reserve regime in October 1990.

Between 1987 and 1990 capital movements were progressively liberalized to comply with the requirements set by the single market of the European Monetary System (see box 1). The most important measure became effective on October 1, 1988, when most capital movements, except those involving monetary instruments, were liberalized. The fear that liberalization would create massive outflows of capital proved unfounded. Indeed, substantial portfolio adjustment by Italian residents was more than matched by a simultaneous capital inflow, for a net inflow of funds. Annual gross financial transactions with foreign counterparties, as recorded in balance-of-payments statistics, rose from 60 percent of GDP in 1987 to more than 350 percent in 1993.

After financial liberalization—Italy's search for stability

The speed of liberalization: gradual vs. big bang approach

The bulk of the abolition of capital controls was carried out between October 1988 and December 1990. Italy's experience can be placed between a gradual approach and a big-bang solution since the abolition of controls, when carried out, relied on a solid domestic financial and credit system. The reaction of Italian residents was much more gradual than the authorities' moves: the adjustment of residents' portfolios was slow, also in international comparison. Several factors explain the persistent home bias of Italian investors. On the retail side Italian securities and tax-related considerations provided higher returns. In the wholesale market the role of institutional investors was very limited, particularly pension funds, usually more prone to diversify internationally their assets.

While external liberalization could rely on a sound financial system, it could not count on strong underlying macroeconomic variables. Two severe currency crises hit Italy in the first half of the 1990, caused by the interaction between huge budget deficits, large current account deficits, full capital mobility, and, until 1992, fixed nominal exchange rates.

Macro imbalances and currency crises in the 1990s

The real appreciation of the exchange rate after 1987, while putting downward pressure on domestically generated inflation, widened the current account deficit, which resulted also from the significant absorption of savings caused by the high public deficits (Fazio 1995b). Doubts about the sustainability of the exchange rate regime emerged, with no clear signs of the political resolve to correct the fiscal imbalances. Italy's exchange rate policy in the 1980s and early 1990s shows how liberalization and underlying imbalances can interact to provoke a currency crisis. In the second half of the 1990s Italy aligned its monetary, fiscal, and income policies to strengthen its external position and benefit from the increased integration of goods and capital markets (Fazio 1995a; Rinaldi and Santini 1998).

Italy's exchange rate policy and external position until 1990. Despite the balance-of-payments deficits associated with the oil crises, Italy still had a modest net creditor position in foreign assets in 1984, thanks to the substantial current account surpluses accumulated in the 1960s and early 1970s. The restrictive monetary policy pursued in the 1980s and the stability of the exchange rate reduced inflation, but they did not eradicate it. Large fiscal deficits led to substantial growth of the public debt and, despite the high domestic saving rate, Italy became a net external debtor in 1985.

At the end of 1986 the real effective exchange rate based on consumer prices was up more than 26 percent from that in January 1979, one of the lowest levels in the 1970s. Measured on the basis of producer prices, the loss of competitiveness was only 12 percent, but it has to be set against large gains by France and Germany. Italy's external current account remained almost continuously in deficit until 1992, owing to the loss of competitiveness and the growth in domestic demand fueled by the fiscal deficit.

In 1990, after two years of small fluctuations of the lira around its central rate, Italy moved to the narrow fluctuation band of the Exchange Rate Mechanism. The removal of controls on short-term flows completed the process of liberalizing capital movements—with an immediate positive effect. There was an inflow of capital, albeit mainly short-term, and interest rates declined. As the trade deficit deteriorated, Italy's net external liabilities mounted, mainly in short-term borrowings. In 1992 the country's net debtor position reached 165 trillion lire, about 11 percent of GDP.

On the basis of consumer prices, the real effective exchange rate of the lira was around 35 percent higher in September 1992 than in January 1979. On the basis of producer prices the rise was less than 20 percent.

The lesson from this experience: monetary policy can be effective. But if other policies do not pull their full weight, disequilibria develop elsewhere. In Italy's case, high interest rates were accompanied by a slowdown of investment and growth, a mounting public debt, and growing foreign debt, with risks for the preservation of monetary stability.

The crisis of 1992 and Italy's withdrawal from the European Monetary System's Exchange Rate Mechanism. On September 13, 1992, with severe tensions affecting international markets, the decision was taken to realign the lira's central rate by 7 percentage points, to regain the competitiveness lost since the previous realignment within the System in January 1987. The general crisis of the Exchange Rate Mechanism later forced the pound sterling and the lira out of the System. The outcome was a real exchange rate of the lira in early 1993 more than 20 percent below the level of August 1992.

The greater price stability of the late 1980s made a decisive contribution to holding down the rise in labor costs. In 1992 the government concluded a first agreement with the social partners to keep future increases in wages and salaries in line with the target rate of inflation, set to diminish rapidly. The Finance Law for 1993 contained measures producing a substantial reduction in the public sector deficit, on a scale comparable to the adjustments after the oil crises. Consumption and output had already contracted sharply by the end of 1992. From 1993 onward the trade balance showed a large surplus.

Despite the devaluation of the lira, inflation remained moderate as a result of the labor cost agreement, the monetary tightening, and the slowdown in domestic demand. After accelerating a little in the spring, inflation averaged slightly above 4 percent in 1993.

In the second half of 1993, following the agreement on incomes policy, money market rates were brought down to a more moderate level, though they remained higher than the average of the other industrial countries. Some of the hot money that had flowed to Italian banks up to August 1992 began to flow out again towards the end of that year, and outflows continued throughout 1993. As a result a more normal composition of the external debt was also restored. There was a further, albeit small effect on the exchange rate.

In the second half of 1993 the effective exchange rate of the lira and interest rates returned to an acceptable equilibrium. The official discount rate was lowered to 8 percent in October. The real effective exchange rate of the lira recovered to a level slightly above the average for 1979 and close to the average for 1980. Yields on 10-year government securities stood at around 9 percent.

Correction of imbalances and the exchange rate crisis of 1995. The second half of 1993 was also the bottom of the economic cycle. The fourth quarter saw a slight upturn fuelled by exports and investment. For the year domestic demand fell by 5.5 percent and GDP by 1.2 percent. Exports of goods and services rose by more than 9 percent, while imports fell by 8 percent. After a long string of deficits, the balance of payments on the current account showed a surplus of 18 trillion lire, against a shortfall of 34 trillion the previous year.

The export- and investment-led recovery was consolidated in 1994. GDP grew by 2.2 percent, and there was a surplus of 25 trillion lire on the external current account. As measured by the cost-of-living index, the 12-month rate of inflation fell to 3.6 percent in July 1994. In the second half of the year there was a slow but continual rise in costs and prices, owing to the pressure of demand, the robust growth of industrial production, and the consequent reduction in idle capacity.

A tight rein was placed on the monetary and credit aggregates. There was virtually no growth in the money supply, and credit to the private sector expanded by less than 2 percent. In real terms all the aggregates contracted.

Inflation increased toward the end of the year, primarily owing to the depreciation of the lira and the rise in international raw material prices. The 1995 hike in indirect taxes in the spring fiscal adjustment package also affected inflation.

The nominal effective exchange rate of the lira at the end of 1994 was 7 percent lower than in the second half of 1993. For most of 1994 the lira followed the dollar, whose depreciation against the Deutsche mark and the yen was also reflected to some degree by the other weak currencies, such as the pound sterling, the Canadian dollar, and the Swedish krona. By contrast, the French franc and the other currencies more closely linked to the Deutsche mark recorded a slight, continual appreciation during 1994.

In December 1994 and the early part of 1995 the Mexican crisis erupted. Wide and disorderly fluctuations of the exchange rates of the main currencies ensued. The dollar fell 10 percent, with the other weak currencies following in its wake. The Deutsche mark appreciated in just a few months by more than 5 percent and the yen by around 16 percent. The lira fell sharply; by mid-March, with domestic political developments also a factor, it had depreciated by more than 15 percent with respect to its average value in December. The exchange rate crisis remained acute until mid-April.

In February 1994 rates rose in response to the shift in U.S. monetary policy, reversing the downward trend of market interest rates in all the main countries. Liquidity began to tighten in Italy as early as June 1994. In mid-August official interest rates were raised by half a percentage point. The rise in market rates was larger in Italy than elsewhere. In February 1995, with worsening inflation expectations and a weakening lira, it was decided to raise the discount rate by another 0.75 points and that on fixed-term advances by 1.25 points.

Both the rigorous fiscal measures adopted in March, bringing an annual adjustment equal to 1.5 percent of GDP, and the monetary tightening aimed to halt the fall in the internal and external value of the lira. As early as 1994, the worsening of the exchange rate and inflation was accompanied by a further, marked acceleration in industrial production. Economic activity is boosted in countries whose currency depreciates. In those where it appreciates, there is an adverse impact on productive activity.

In February 1995 the U.S. Federal Reserve raised official rates again. In Germany and Japan, currency appreciation, stable or declining prices, and sluggish economic activity led the monetary authorities to lower official interest rates in the spring.

The further tightening of monetary policy in 1995 and the recovery of the lira. In early 1995 Italy's annualized monthly inflation rose to between 5 and 6 percent. On May 26, with economic activity growing rapidly, the official discount rate and the rate on advances were raised by another 0.75 percentage points to check the deterioration in inflation expectations. Control of liquidity was made even more stringent. And the effects of the monetary and fiscal tightening on domestic demand began to appear.

Compared with its lowest value in the wake of the Mexican crisis, the lira's exchange rate had already recovered by more than 8 percent between mid-April and mid-May. The dollar and the other weak currencies also appreciated, while the Deutsche mark and particularly the yen lost part of their earlier gains. The recovery of the dollar continued over the summer, partly as a result of massive and coordinated intervention and the further reduction in interest rates in Germany and Japan.

By mid-September the effects of the tensions triggered by the Mexican crisis had been largely absorbed. Compared with December 1994, the depreciation of the lira, which had exceeded 15 percent in March, was no more than 3 percent. The turbulence reversed part of the gains recorded by the weak currencies. The depreciation of the lira, moving in line with the dollar, increased again to around 5 percent.

Market yields on 10-year government securities, above 12 percent in the closing months of 1994, reached 13.7 percent in the period of the lira's maximum depreciation, between the middle of March and the middle of April 1995. After falling later to 11 percent, they rose in response to the turbulence to around 11.5 percent. The differential with Germany was about 5 percentage points.

Inflation abated considerably over the summer. In the third quarter the annualized monthly increase in the cost-of-living index, net of indirect taxes and seasonally adjusted, was 1.5 percentage points less than in the second. The tightening of monetary policy, the recovery of the lira, and the slowdown of the cyclical expansion braked inflation. So Italy's experience in the 1980s and 1990s shows that a rigorous monetary policy can curb inflation.

Public finances. The prospects for the internal and external value of the lira depended crucially on those for the public finances. The adjustment that began with the measures adopted in 1992 significantly curbed the expansionary trends that for many years had marked public expenditure. Major reforms were carried out in health services, public employment, local finances, and social security. The reform of the pension system was of major importance. The Italian pension system was out of line with those of other leading European countries, mainly owing to the lower retirement age and the more generous link with earnings.

In 1995 the rising trend of the ratio of public debt to GDP was halted, thanks to privatization proceeds. At the end of 1995 the ratio of general government debt to GDP was at 123.8 percent, compared with 124.3 percent at the end of 1994. This ratio remains much higher than in other industrial countries. It needs to be remembered, however, that Italian households have a particularly high saving rate and carry little debt. This leads them to accumulate financial assets, notably public debt securities. In relation to GDP, total financial wealth in Italy is in line with that of the other leading countries.

The high rate of domestic saving made it possible to limit the country's external debt. The surpluses earned on the current account of the balance of payments recorded from 1993 onward allowed Italy's net external debt to fall gradually until the country became a net creditor in 1999.

Conclusions

In the second half of the 1990s several interacting forces—the need to make Italian financial markets and securities more competitive and the run-up to the single market and single currency—led Italian authorities to modernize domestic financial markets and liberalize capital flows. The approach was gradual in market reform and modernization, whereas the tight deadlines for the single market led to a relatively quick dismantling of capital controls (the bulk between October 1988 and December 1990). While the direct and indirect benefits of liberalization are undisputable, Italy had to bear severe costs due to two currency crises. The severe macroeconomic imbalances in the 1980s were at the root of the currency crises of 1992 and 1995. And capital mobility exposed those imbalances, forcing authorities to correct them. Against this background, one possible lesson of Italy's experience for other countries, especially emerging economies, is that financial liberalization—and the sequencing of the related steps—has to be accompanied by the correction of structural imbalances.

Note

1. The description of the development and the features of Italy's financial system in the post-war period—a mixture of private initiative and public sector intervention—goes beyond the scope of this note. But for a number of reasons in the 1980s, at the early stages of the process of European monetary unification, Italy's financial system was characterized by a relatively high degree of regulation. The aim of this paper is to provide an historical perspective of the major changes occurred in Italy in the 1980s up to early 1990s, when the liberalization of capital flows was completed. So, it does not include the recent developments that contributed to create the current organization of the Italian financial system.

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Japan

Foreign exchange transactions, capital flows, and financial businesses have been liberalized gradually, with dynamic economic growth and an increased current account surplus since World War II. Foreign exchange regulations were abolished in 1964 to comply with Article VIII of the IMF's Articles of Agreement. The gradual liberalization of trade and investment and coordination of ministries and agencies concerned helped cope with Japan's huge current account surplus. And short-term capital flows were liberalized after 1970, with Japan's robust economic growth, current account surplus, and accumulated foreign reserves. The Foreign Exchange and Foreign Trade Control Law allows regulation of capital flows as a means of risk management for immediate threats to the balance of payment and markets (but these regulations have never been applied). Domestic liberalization has proceeded more slowly, driven by foreign exchange and capital transactions.

Postwar period to 1960

The Foreign Exchange and Foreign Trade Control Law was promulgated in December 1949 and banned foreign exchange transactions except by government or ministerial ordinances. Under this law, private entities were banned from holding foreign currency. Residents were obliged immediately to sell any foreign currency to the government through authorized foreign exchange banks. Initially, the exchange rates between customers and the foreign exchange banks, and between the banks and the government, were officially fixed. All foreign currencies were government controlled—there was no room for a foreign exchange market.

With the revival of the Japanese economy after World War II, foreign trade shifted gradually from the government to the private sector. The private sector could time receiving export proceeds and paying import obligations to move a large amount of capital across the border (leads and lags). So, new regulations were set out to restrict such actions.

Foreign currency was allocated for external payments through *gaika yosan seido*, an institutional budget for foreign currency. Nonresidents could not exchange yen into foreign currency, and yen-denominated financial assets held by foreigners were limited. The Foreign Capital Law also began regulating investment, such as foreign direct investment and technical transfers.

Foreign exchange controls were intended to use Japan's limited foreign reserves effectively by priotizing transactions and restricting unimportant ones.

From 1960 to 1973—end of the fixed exchange rate regime

Becoming an Article VIII nation of the IMF

After World War II, the Japanese economy achieved high growth rates and a rapid expansion of trade while facing balance of payment difficulties. Under these conditions, the government published "The Outline of the Plan for Liberalizing Trade and Foreign Exchange" in June 1960 as a step toward accepting Article VIII of the IMF Articles of Agreement and joining the Organisation for Economic Co-operation and Development (OECD). In July, nonresidents were permitted accounts to deposit yen for current transactions settled in yen, a step toward the revival of yen convertibility. In September 1960, restrictions on borrowing without collateral and regulations on the foreign exchange spot position of foreign exchange banks were removed.

These ambitious measures stagnated and were partly reversed in 1961 and 1962 when measures against the shortage of foreign currency were implemented, in effect until January 1963. For example in June 1962 the reserve deposit requirement system required foreign exchange banks to have 20 percent of their debts denominated in foreign currency. From 1962 to 1963, when the short-term inflows of foreign capital seemed to increase, the reserve requirement was raised to 35 percent. In late 1962, the period of deferment was shortened for the share remittance of principal and in 1963, it was abolished. Capital transactions were further liberalized with a unified system of permission of foreign capital. Under the Foreign Capital Law, outflows were liberalized—but inflows strictly examined. With other transactions, capital inflows were liberalized and outflows not permitted. In 1963 the procedures to control capital inflows and outflows were unified.

The first official intervention by the Japanese government in the foreign exchange market was in April 1963, in preparation to remove the exchange controls on current transactions. Before then, foreign currency had been bought and sold passively through a special government account for foreign exchange under official exchange rates. Since that intervention, the foreign exchange rates fluctuated within the range of 0.75 percent around 360 yen per dollar and the government intervened in the foreign exchange markets flexibly within this range. With this development, the trading volume in the Tokyo foreign exchange market expanded rapidly.

In April 1964 Japan accepted Article VIII of the IMF Articles of Agreement and removed exchange controls on current transactions. The *gaika yosan seido* was abolished and replaced by an import quota system. Yen could be freely converted into foreign currency for import of goods and services. With the removal of the exchange controls on current transactions, capital transactions concerning trade were also liberalized. In the 1960s, as Japan's foreign trade expanded, capital transactions necessary for international trade increased.

When Japan became an Article VIII nation of the IMF and joined the OECD, 92 percent of trade items had been liberalized, with only 192 remaining.

Liberalization of capital flows

The next industrial challenge for Japan in the mid–1960s was to liberalize capital transactions—not only removing the restrictions on the flow of foreign capital, but also changing industrial policies by controlling capital that directs economic activities. Liberalization in capital transactions developed progressively in close consultations with many international institutions and through various domestic deliberations, because this policy affects foreign capital and the liberalization of trade, such as tariffs in each industry.

In July 1964 the OECD strongly urged members to deregulate their capital transactions. Japan reserved 18 of 37 items under the OECD requirement, meaning liberalization of capital transactions was comparatively behind.

Discussion of capital liberalization indicated the future direction for liberalization:

- For government, to establish a well-developed industrial system, promote reforms in companies, and support technical development.
- For industry, to introduce foreign capital in a voluntary, independent, and responsible way while strengthening cooperation among companies and establishing cooperative bodies within industry.
- For foreign interests, to bring capital in an orderly way, supporting coexistence, coprosperity, and adherence to the domestic legal and economic order.

In July 1967 the first set of capital liberalization measures was implemented: the "automatic authorizing rule" and the "50 percent rule" were introduced for 50 industries. In 1969 the second set of capital liberalization measures was applied to 155 more industries, liberalizing about 30 percent of all industries.

Capital controls in Japan after becoming an Article VIII nation of the IMF

Except in fiscal 1967 when the current balance fell into a deficit with the expanding economy, increases in exports kept the current balance in surplus until fiscal 1970, increasing foreign reserves.

With foreign reserves rising rapidly in fiscal 1968, restrictions were contemplated—a major policy shift. Japan's foreign reserves were rising while many countries suffered shortages. And short-term inflows were disturbing domestic financial markets and foreign exchange markets.

Not until 1969 were measures to restrict the rise in foreign reserves implemented. As exports were growing and the official discount rate was raised, so it was expected that the other countries would ask Japan to revalue the yen. In 1970 exports continued to increase, though several trade financing measures were implemented and restrictions against short-term capital inflows were introduced.

1973 to 1980—transition to a floating exchange rate

Exchange controls during the transition to a floating exchange rate

After Japan shifted to a floating exchange rate, exchange controls were still strict and the exchange rate was determined by the government, just as under the fixed exchange rate system. But the current account balance fell into deficit, which grew because of an overheating economy, appreciating yen, and the first oil crisis in 1973. The yen depreciated as prices rose rapidly and the current balance deteriorated.

Exchange controls during the period of appreciation and depreciation of the yen

At the end of 1973, the regulation restricting a net increase of inward securities investment was removed, and the reserve deposits for nonresidents holding yen were lowered. In January 1974, a voluntary guideline to restrict the net increase of outward investment was introduced for banks, securities companies, investment trust funds, and insurance companies. A regulation to restrict the net increase of bank deposits in foreign currency held by residents was also introduced.

In 1976 the current account surplus expanded, and in 1977 the external assets of the private sector began to increase. The yen began to appreciate. The government intervened to buy dollars, ease the regulation on capital outflow, and strengthen the capital inflow regulations. In June 1977 the regulation on the balance of residents' deposits in foreign currency was removed, and the measure that prohibited residents from acquiring short-term foreign securities was abolished. In April 1978 foreign currency deposits converted from yen were permitted up to the amount of 3 million yen. Regulations on inward investment were temporarily strengthened with the yen's extreme appreciation. In March 1978 nonresidents were prohibited from acquiring yen-denominated bonds, except those with maturities shorter than five years and one month and those issued by foreign entities. As a result, it was very difficult for nonresidents to invest in yen, and the spread between the euro-yen rate and the *gensaki* rate (which should be zero without exchange controls) was large from late 1977 to early 1979.

These regulations on inward investment were eased following U.S. President Jimmy Carter's announcement of measures to protect the declining dollar, and were completely abolished by February 1979. In May 1979 the maturity term of import usance was extended, and short-term impact loans from abroad were permitted. Nonresidents were permitted to participate in the *gensaki* market, and CD markets open to nonresidents were founded. As a result, capital flows became more active, explained by the fact that the euro-yen rate was almost identical to the *gensaki* rate. In March 1980 regulations on interest rates for yen-denominated deposits of foreign official institutions were abolished.

Capital transactions

In September 1970 the third set of capital liberalization measures was implemented in 323 industries. In August 1971 the fourth set of capital liberalization measures was announced. The regulatory framework was changed to allow up to 50 percent participation by foreign capital as the principal. Targeted industries for liberalization were significantly expanded. Amid further external disequilibrium, the fifth set of capital liberalization measures was implemented in 1973. At that time, full participation of foreign capital was set as the principle, except for 17 industries with a sunset clause. Still, conditions were placed on the acquisition of equities using foreign capital for a takeover, including approval of the targeted company's manager.

Amendment of the Foreign Exchange and Foreign Trade Control Law

After the G-7 Summit in 1976, Japan had to recognize its position as an economic superpower. While Japan's current account balance recovered steadily, other economies stagnated. It became difficult to ignore external economic conditions, leading Japan to promote liberalization and internationalization with an increasing current account surplus.

After early 1977, given the international friction caused by a rapid increase in its current account surplus, Japan moved to modify the Foreign Exchange and Foreign Trade Control Law to demonstrate its openness to the international economy. In May Japan decided to completely deregulate foreign exchange controls. The foreign exchange banks were deregulated, including abolishment of the regulation on short-term capital transactions and easing the regulation on medium- and long-term capital transactions, and deregulation of foreign currency liability by foreign exchange banks. And as a positive step for the Tokyo Round of GATT, tariff reductions and enhanced financing for imports were announced.

In January 1978 further measures for the liberalization of exchange controls were announced. The broad range of measures permitted flexibility in the standard settlement system, guarantees, remittances, gold transactions, real estate transactions, technology imports, foreign deposits, foreign direct investment, carrying out of yen, licensing of foreign exchange banks, and hedging operations for outward securities investments.

In May 1979 seven measures for promoting capital inflow were announced. They extended maturity terms of import usance, abolished the regulation on prepayment for exports, abolished the waiting period to covert yen-denominated foreign bonds into dollars, eased usage of proceeds from long-term impact loan, freed short-term impact loan, and allowed nonresident participation in auctions of yen-denominated foreign bonds and *gensaki* transactions. With these measures, the amended Foreign Exchange and Foreign Trade Control Law was put into place well before its formal promulgation.

In December 1980 the amended Foreign Exchange and Foreign Trade Control Law was officially implemented, shifted the principle of foreign exchange transactions from prohibition to freedom. This amendment legally established the liberalization of exchange rate transactions and with the liberalization of current and capital transactions, the legal structure was completely changed.

Under the amended Foreign Exchange and Foreign Trade Control Law, capital controls can be activated only when it is extremely difficult to maintain equilibrium in the balance of payments, foreign exchange rates fluctuate significantly, and cross-border capital flows have a serious impact on financial capital markets—but they have never been activated. The amended law liberalized deposits in foreign currencies at Japanese foreign exchange banks by residents (including selling yen), and loans in foreign currencies from Japanese foreign exchange banks (such as yen impact loan). For inward-outward securities investments through specified securities companies, notifications to the authority became unnecessary. As a result, residents came to hold foreign currency-denominated assets freely, substantially changing Japanese foreign exchange controls and removing almost all restrictions on the convertibility of the yen.

The expansion of foreign currency-denominated financial transactions inside Japan has been a primary factor promoting liberalization of interest rates on short-term yen financing, since they are in effect equivalent to those denominated in yen, by hedging through forward exchange contracts. This shows how liberalization of foreign exchange transactions can promote a domestic financial liberalization. Foreign currency deposits bear foreign exchange risk and cannot be substituted for a yen-denominated deposit. But they are identical to a yen-denominated deposit with market interest rates if foreign exchange risk is avoided through hedging.

A loan from abroad with covered transactions by future contrasts can be identical to a yen-dominated loan with market interest rates. It is also outside the "window" operations by the Bank of Japan. Though these transactions cost the participants, since they involve handling charges, liberalization of foreign currency-denominated deposits and loans from abroad have a similar effect as liberalization of domestic yen-denominated deposits and loans with market interest rates because the transaction cost is relatively small for large transactions.

The 1980s

Liberalization of capital transactions

The Foreign Capital Law was abolished following the amendment of the Foreign Exchange and Foreign Trade Law. In 1984 restrictions were abolished for investments by nonresidents in designated Japanese companies (*Shitei Kaisha*), and the reporting period for financial statements by foreign companies was extended from three months to six months after the day of settlement.

In the final report of the "Japan–U.S. Structural Impediments Initiative" published in June 1990, Japan announced its plan to liberalize foreign direct investment. It then began to enact laws to promote imports, facilitate inward investment, implement loans to foreign companies through a favorable interest rate facility, and provide information through the Japan External Trade Organization. In 1992 the Foreign Exchange and Foreign Trade Law was modified again, and ex ante reporting of FDI with government examination was replaced by ex post reporting in principle, with partial ex ante reporting in some cases. The deadline for reporting was changed to no later than 15 days after the transaction.

Financial liberalization

Around 1980 U.S. and European banks and securities companies stepped up their requests for the liberalization of Japan's financial and capital markets and the greater participation of foreign companies in the Japanese economy. They argued that Japan's markets should be commensurate with its status as the world's second largest economic power. Domestic requests for liberalization also soared.

Two reports—"Current Status and Prospects for Financial Liberalization and the Internationalization of Yen" and "Report by the Working Group of Joint Japan–U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues"—expressed positive attitudes toward financial liberalization. With this turning point, Japan began to follow the worldwide trends toward liberalization and globalization. Some believe that the liberalizing of foreign exchange transactions around 1980 gave impetus for the financial liberalization. The plan included:

- *Liberalizing deposit interest rates.* As proposed in "Prospects" and the "Report", permit smaller denomination of CDs with free interest rates, make their terms of issuance flexible, and introduce large-sum deposits with market interest rates.
- *Facilitating short-term financial markets.* Japan's short-term financial markets developed rapidly with the increase of *gensaki* and CDs exceeding 20 trillion yen. But those markets were less flexibile and diverse than those in the United States. To enlarge and enrich such markets, a yen-denominated BA market is planned. It will help internationalize the yen by promoting yen-denominated trade. Additional methods of financing for the short term will increase short-term capital investments and the procurement opportunities for corporations.
- *Diversifying the financial businesses.* Diversification of businesses is as important as interest rate liberalization. "Prospects" specifies plans to improve and increase the flexibility of businesses, such as securities and international business, while respecting the creativity of the private sector.

- *Expanding euro-yen trade.* The "Report" promoted the liberalization of euro-yen trade. Short-term euro-yen loans for both residents and nonresidents were liberalized, as were medium-to-long-term euro-yen loans for nonresidents. Euro-yen CDs and euro-yen bonds were also liberalized.
- *Liberalizing foreign bonds denominated in yen.* In 1984 yen-denominated bonds issued by nonresidents were liberalized.
- *Establishing a Tokyo offshore market.* The Tokyo offshore market was founded in December 1986 for nonresidents to procure necessary financial resources with fewer regulatory limitations. Facilitation of yen-denominated investments and financing from abroad was expected to help advance the internationalization of the yen. The Tokyo market was expected to become a large international financial center like that in New York and London.

In June 1987 the "Current Outlook for Liberalization and Internationalization of Financial and Capital Markets" was released. It outlined the current status of liberalization and the problems to be solved. The report indicated that liberalization and internationalization were proceeding and insisted that Japan should serve as one of the key international financial centers with more consideration on cooperation with other countries. The report suggested:

- Further liberalizing deposit interest rates.
- Enhancing short-term financial markets.
- Improving futures markets.
- Improving capital markets.
- Liberalizing the business of financial institutions.
- Collaborating with other countries to supervise banks and improve their capital.
- Solving the problems of business fields handled by financial institutions.
- Improving methods of access by foreign financial institutions.

1990s—Financial sector reform

Framed in 1992 and implemented in 1993, financial sector reform aimed to move from indirect to direct finance, using the "subsidiary" system to enhance participation in each financial sector. By allowing the establishment of 100 percent subsidiary companies, the problem between industries could be solved while maintaining the basic boundary between the industries. Also, the interest rates on term deposit were completely liberalized in June 1993.

In 1996 discussions on the financial big bang started. In May 1997 the Foreign Exchange and Foreign Trade Control Law was amended as the frontrunner of the financial big bang. The 1980 foreign exchange control system was more liberal than those in Europe. But as cross-border transactions were rapidly liberalized in European countries, the Foreign Exchange and Foreign Trade Control Law had to be amended to make the Tokyo market internationally attractive. Specifically, cross-border transactions were liberalized by the abolishment of the ex ante permission and reporting system in principle, foreign exchange businesses were liberalized completely, and regulations of foreign exchange banking were abolished, ensuring free participation and the withdrawal of foreign exchange businesses.

The financial big bang

To make full use of Japan's household savings of 1,200 trillion yen, free and fair financial markets were needed. In addition, the Japanese financial market was expected to become an international financial market equal to that of New York and London. Three important principles of market structural reform—free, fair, and global—were advocated. A sequence of liberalization measures were achieved: liberalization of subject of investments (such as removal of ex ante regulations on development of new financial products by securities companies); liberalization of markets (such as that of dealing equities using over the counter markets); liberalization of market intermediaries (such as replacement of the license system of securities business with the register system); and liberalization of prices (such as that of brokerage commission fees for equities). With the removal of the license system in the securities businesses, liberalization of financial businesses advanced dramatically.

Republic of Korea

Narrowly defined, globalization may refer to economic liberalization and integration based on global standards. But its implications for individual countries are far more than just economic, as they extend into the realm of social, political, and even cultural development. Indeed, the Republic of Korea has rapidly transformed its economic and social landscape over the course of its outward-looking economic development. With export promotion and foreign capital inducement serving as the main engines of growth, Korea was required to align its socioeconomic institutions and policies with global market standards. But in contrast to the high level of economic integration in trade, the financial sector had been little exposed to global competition until the outbreak of the East Asian crisis in 1997. Consequently, the discrepancy between global and local standards grew in the financial sector, and impeded the development of economic institutions and policies suited to a globalized market environment.

In this sense the unfolding of Korea's crisis in 1997 provides an excellent case for the study of the crucial issues surrounding globalization—particularly the complex dynamics of capital market liberalization. The 1997 crisis was not just a simple liquidity crisis. Rather, it reflected a culmination of structural imbalances and institutional shortcomings in Korea's economic system magnified by a delay in alignment of local to global standards.

Given this prognosis, structural remedies were called for. Indeed, the crisis provided critical momentum for Korea to address the challenges posed by globalization. The economy was made fully open to financial flows, which—unlike trade flows—had not been fully liberalized. Increased economic openness served as an important catalyst for comprehensive economic reforms on the domestic front and expedited Korea's transition to a fully open market economy. Thus this case study focuses on capital account liberalization and related institutional reforms.

Overview

The most unique feature of Korea's economic development is the government's strong leadership in resource allocation. Industrial policy has been at the heart of this leadership. The government selected so-called strategic industries and firms and provided them with formal and informal incentives, particularly financial favors in the name of policy loans. Entry barriers were also implemented to protect firms in strategic industries from competition. The results were rapid growth of investment and output, largely led by family-controlled business conglomerates, referred to as *chaebols* in Korea.

But the government's visible hand in financial resource allocation in the early stage of Korea's development was also the prelude to more extensive government control and pervasive moral hazard in the later stage. Fruits of business success accrued to owners and employees of chaebols while investment failures were often passed on to the public. Prudential regulation and supervision of the financial sector were insufficient. The emergence of highly leveraged chaebols with enormous market share in both product and factor markets increased Korea's vulnerability to cyclical shocks.

Deteriorating macroeconomic performance in the late 1970s, especially in terms of rising inflation and growing imbalances in the external current account, gave rise to criticism of the government-led development strategy that had been maintained for two decades. The first major momentum for liberalization was provided by the heightened economic instability of 1980, triggered by domestic political unrest and the second oil shock. The global trend toward economic liberalization since the beginning of the 1980s also affected, at least partly, Korea's domestic liberalization process. Consequently, macroeconomic policy instruments were redirected toward price stability during the first half of the 1980s, while industrial policies were partially lifted, with the gradual phaseout of policy loans.

In contrast to the ardent macropolicy reforms, however, progress in micropolicy reforms, particularly in the financial sector, lagged behind. Indeed, when Korea returned to remarkable economic growth with large current account surpluses in the second half of the 1980s, rising pride about the Korean economic system began to outweigh suggestions for further reforms toward global standards. And the government's control in the financial sector, albeit lower than in the 1970s, continued despite the privatization of banks.

In the late 1980s financial liberalization resurfaced as an important policy agenda as Korea significantly improved its balance of payments. In 1990 the exchange rate system was reformulated to allow greater flexibility. In the domestic market, interest rate deregulation was implemented in a more systematic way, although the process was often hindered by market reactions. But the most meaningful step in terms of financial globalization was made in 1992, when the domestic equity market was opened to foreign investment. After that capital account liberalization made steady progress before it was further accelerated in line with Korea's accession to the Organisation for Economic Co-operation and Development (OECD) in 1996.

The 1990s also witnessed significant progress in trade liberalization. The inception of the World Trade Organization (WTO) provided critical momentum for import liberalization, although trade liberalization had been evolutionary in the context of the outward looking development strategy. In fact, it was in the mid-1990s that the government first used the concept of globalization as key rationale for its comprehensive economic reforms.

Despite the increasing exposure to global forces, however, much-needed reforms were not carried out in a timely manner. The government's basic modus operandi for financial policy changed only slightly. Business practices and the mindset of the private sector also underwent little change. Fundamental market infrastructure, such as an institutional framework to ensure transparent corporate governance and sound practices of financial institutions, was not properly established. As a result structural imbalances between global and local standards intensified. In short, in the 1990s Korea was slow to adapt itself to rising global standards, and was hit by the 1997 crisis.

The 1997 crisis was a turning point in Korea's economic history, representing painful evidence of the challenges posed by globalization and Korea's limited responses. Although it was a crisis of the capital account and not the current account, which was relatively new to Korea, its impact was not confined to the financial sector because it also represented collapsed confidence of the global community in Korea's old economic system. Indeed, dramatically increased economic openness after the crisis served as an important catalyst for upgrading economic institutions and legal frameworks to be on par with global standards.

Domestic economic policy reforms

Macroeconomic policy reforms

In 1980 the adverse impact of the second oil shock hit Korea hard. Economic growth plummeted to a negative figure, while inflation soared to almost 30 percent. The external balance also worsened significantly, with a current account deficit of more than 8 percent of GDP and government budget deficit over 3 percent of GDP. Political instability added further uncertainty to the economy. Even facing such hardships in every dimension, however, the government placed top priority on economic stabilization rather than growth promotion—and the results were quite successful, with price stability fully restored by the mid-1980s. This reorientation of macroeconomic policy was firmly preserved for almost a decade. At the same time, many important macropolicy reforms were successfully carried out in the early 1980s.

Monetary policy. One of the important ideological changes in 1980s was that monetary policy should aim at promoting price stability rather than supporting industrial policies. Despite the recession, monetary policy was drastically tightened in the early 1980s, as manifested by a sharp fall in the growth rate of base money to virtually 0 percent during 1980–82, down from around 30 percent in the late 1970s (figure 1). As a result inflation subsided to about 3 percent, down from 20–30 percent in the late 1970s. Such success in the disinflation policy provided an important platform for globalization in that it significantly reduced economic uncertainty associated with international transactions.

However, management of M2 targeting exhibited potential problems. For example, even when domestic liquidity supply was clearly excessive in the late 1980s, as reflected by an explosive increase in the base money and many other financial variables, the government emphasized the M2 target (see figure 1). Another problem was the way the central bank controlled monetary aggregates. The central bank assigned monetary stabilization bonds to commercial banks through closed windows rather than open and transparent markets.

This convention, along with the M2 targeting, was almost abolished with the currency crisis. First, to cope with the collapsing currency value, the International Monetary Fund (IMF) raised overnight interbank call rates dramatically. That is, the monetary authority began to use the short-term interest rate as an explicit intermediate target, with monetary aggregates as information variables only. In the swirl of financial crisis and drastic financial reforms, the stability of monetary aggregates was seriously damaged (figure 2), further justifying the interest rate targeting. The decline in the need to hit a quantity target then reduced the authority's guide at the bank windows.

Today the monetary policy is conducted under the new legal mandate of inflation targeting, with the short-term interest rate as the intermediate target. This scheme, along with the free-floating exchange rate, appears to be consistent with the environment of the Korean capital market, which is now completely open.

Liberalization of interest rates was another important reform related to monetary policy. Although there were recurrent objections to this, interest rates set by the government in the 1970s were liberalized throughout the 1980s and 1990s in a gradual manner, as can be seen from the steadily reduced discrepancy between curb market and institutional interest rates (figure 3). The preferred interest rates applied to policy loans were also gradually abolished.

Figure 1. Trends in M2 and M3

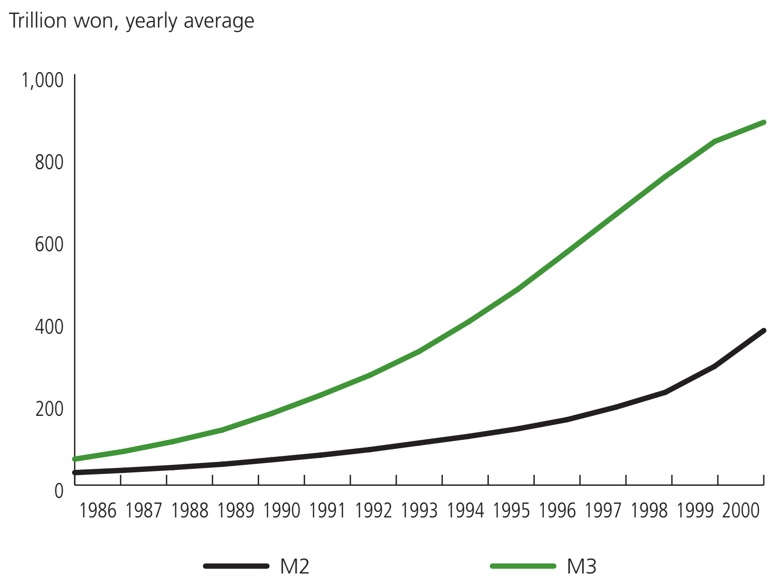


Figure 2. Growth rates of monetary aggregates in Korea, 1972–2002

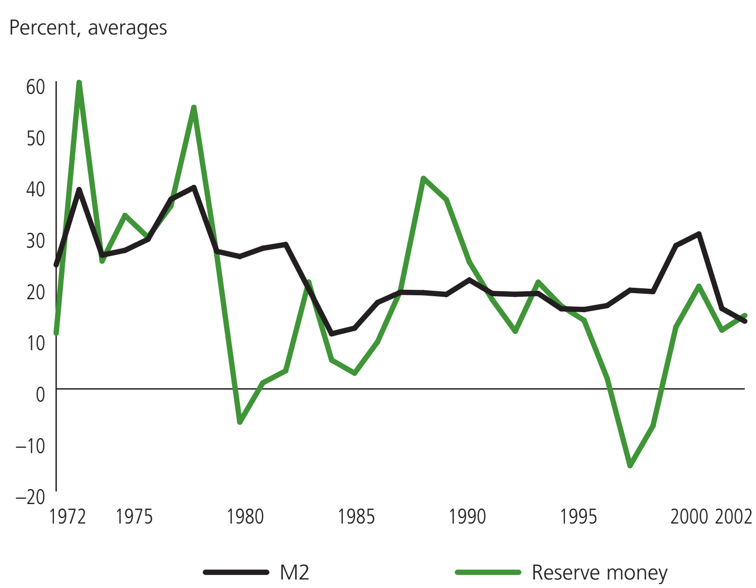
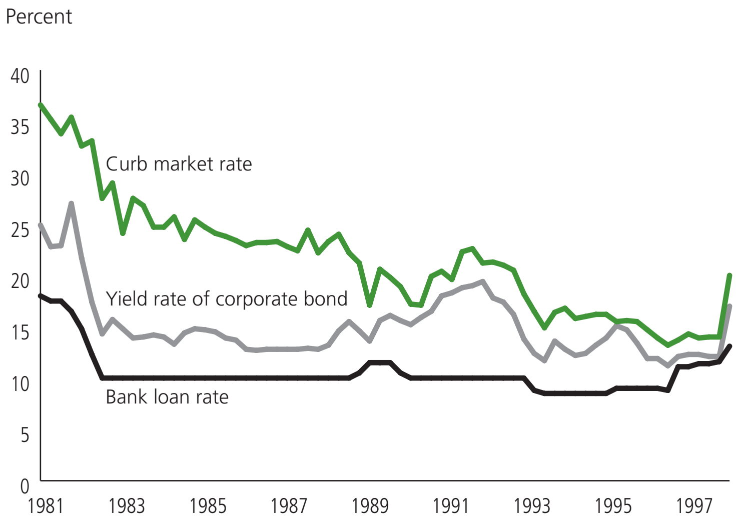


Figure 3. Trends in interest rates in Korea, 1981–97



Exchange rate system

With the rapidly expanding current account deficit in 1980, the balance of payments had to be stabilized. The won-dollar exchange rate that had been fixed since 1974 was devalued by 20 percent in January 1980, then a multiple currency basket system replaced the fixed exchange rate regime. Under this new system the government still set and announced the exchange rate, but the substantial differentials between domestic and foreign inflation rates began to be explicitly considered.

Because Korea had accumulated a substantial current account surplus by the end of the 1980s, confidence regarding the balance of payments was built up among policymakers, and the exchange rate system was further reformed into the market average exchange rate system in 1990. This new system was an advancement toward free market rates in that the exchange rate was basically determined through demands for and supplies of foreign currencies in exchange markets, rather than by discretionary judgments made by the government.

Nevertheless, the foreign exchange market was not completely left to market forces. And market participants were inclined to believe that the exchange rate would not deviate much from the range that the government had in mind. This belief, however, was changed with the currency crisis in 1997. Finally, the completely free-floating exchange rate system was introduced with the full-scale capital market opening in December 1997.

Fiscal policy

Fiscal policy was also reformed in the early 1980s. Many tax incentives supporting strategic industries were phased out, and the zero-base principle was applied to budget planning. Specifically, the automatic budget increase for government projects year after year came to a halt, and each project was required to provide justification for the increase.

A prominent result of this policy was the negative growth rate of government expenditure (in real terms) in 1981. As a result the consolidated budget deficit gradually approached balance in the early 1980s, and the balanced budget policy became a tradition. Although a rather rigid government attitude marred fiscal flexibility (such as automatic stabilizers), this long-standing tradition of the balanced budget preserved the fiscal soundness that played an important role in the Korean economy's recovery from the currency crisis.

Microeconomic policy reforms

Financial market. Throughout the 1960s and 1970s domestic financial markets and institutions were subject to extensive government supervision. Interest rates were regulated, while credit allocation was largely in the hands of government-owned banks. In the 1980s the government began reforming policies to improve financial market efficiency. Two policy measures are notable: privatizing banks and fostering the development of direct financial markets.

The government divested nationalized banks between 1980 and 1983 based on the premise that establishing a market-based ownership and governance structure should be the first step to improve the efficiency of financial institutions and markets. The privatization of banks, however, did not produce the intended effects because the banks lacked experience.

The development of capital markets yielded more pronounced and lasting impacts on financial markets and industry. The major motivation for capital market development was to provide firms with alternative source of funding and to mitigate the concentrated ownership structure of the industrial sector, particularly chaebols. The main focus of the government's effort was given to the development of the corporate bond market and stock market. Most notably, institutional investors such as investment trust companies and bank trust departments were established in the late 1970s and early 1980s. These financial intermediaries in direct financial markets rapidly increased their share in financial flows. Accordingly, the dominance of banks in the financial market gradually dwindled, as reflected in the growth pattern of M3 relative to M2.

The rapid expansion of the nonbanking sector continued throughout the 1990s as entry barriers in the sector kept being lowered. Accordingly, competition for funds intensified between banks and nonbanks. These developments, in conjunction with weak internal governance of banks, undermined the profitability of banks and made the financial sector vulnerable to cyclical shocks. But the regulatory and supervisory system was unable to properly respond to the situation. Capital account liberalization took place in this shaky environment, exposing the economy to potential systemic risks that were eventually realized in the 1997 crisis.

After the crisis most banks were effectively nationalized as the government injected public funds to support their recapitalization. Given this, bank governance reform remains one of the main tasks for financial sector reform. However, the regulatory framework was greatly upgraded. To foster market competition and discipline in the nonbanking sector, entry barriers were further lowered and foreign participation liberalized. Global standards were instituted for bank regulation and supervision, including prompt corrective actions and new accounting and loan classification standards, among others. In addition, the deposit insurance system was reformulated to better deal with systemic risks and potential moral hazard by providing only partial coverage to deposit-taking institutions.

Corporate governance. In the early 1980s *chaebols* began increasing their influence in the financial sector through the ownership of nonbank financial institutions such as merchant banks, security companies, investment trusts, and insurance companies. Their increasing control weakened external governance of corporate management and created the possibility of inefficient—and often reckless—corporate investment. In addition, the lack of an outsider director system and of transparency in accounting information aggravated agency problems.

The government-business risk partnership became increasingly dysfunctional in the era of liberalization and democratization. The desirability and effectiveness of the state-led monitoring and incentive system were greatly reduced, but few financial institutions or institutional investors were ready to step in to serve these functions. Moreover, the government was slow in promoting competition and creating conditions for autonomous financial institutions to develop. Quantitative restrictions on credit and in-group investment were the main instruments of competition policy. Although these measures were intended to address the problem of economic concentration and to contain potential systemic risks, they were insufficient in compensating for the lack of market discipline imposed on corporate management and investment.

Labor market and social safety net. After Korea was politically democratized in 1987, workers demanded wage increases as well as full-fledged rights to organize and take collective action. Business executives complained that lifetime employment practices impeded corporate restructuring and flexible adjustment to rapidly changing global markets. A grand bargain between labor and management would have involved enhanced worker rights and social security in exchange for increased labor market flexibility. Repeated attempts by the government to broker such an agreement between the two sides, however, resulted in protracted gridlock. In fact, only in the wake of the 1997 crisis did the two sides agree to increase labor market flexibility and enhance worker rights. After the crisis the government strengthened the social safety net to address not only soaring unemployment but also structural changes in employment practices.

Capital account liberalization

Though the nominal anchor approach of the 1970s was replaced by a more flexible real target approach in 1980 with the introduction of the multiple currency basket peg system, exchange rates remained policy variables in Korea throughout the 1980s. Therefore, Korea's policies on capital flows in the 1980s were dominated by the necessity of balancing the current account and were pursued in a passive manner. Hence in the first half of the 1980s, when current account showed deficits, various regulations on banks and corporations were lifted to induce capital inflows.

But in the mid-1980s, when the current account balance began to show large surpluses in the wake of the realignment of major currencies, the policy stance toward capital inflows changed dramatically (figure 4). Foreign commercial loans to domestic firms, with the exception of public enterprises, were prohibited. Overseas issuance of bonds and depository receipts by residents was also restricted. In addition, banks were advised to reduce their exposure to external debt.

Gradual liberalization in the 1990s and the 1997 crisis

Characteristics of liberalization policy. As the Korean economy achieved fast economic growth, internal demand for low-cost capital in the private sector kept rising, strengthened by liberalization pressures from capital-exporting countries. Hence, in tandem with the reform of the exchange rate policy in 1990, capital account liberalization was considered in its own right for the first time, and the government began adopting liberalization measures.

The approach adopted can be summarized as:

- Liberalize capital flows by domestic banks first.
- Liberalize trade-related short-term capital flows for nonfinancial corporations.
- For other capital flows, either defer liberalization or liberalize with restrictions.

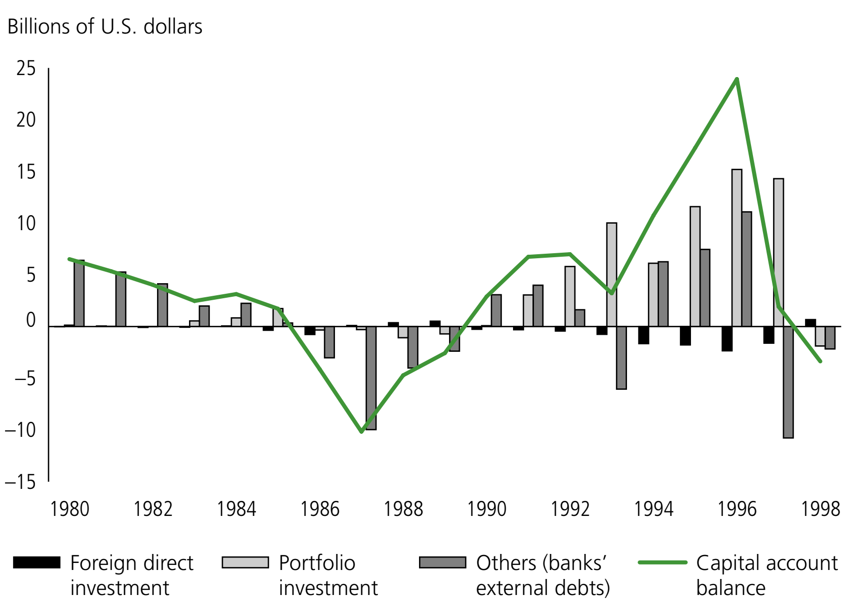
The major rationale behind the policy stance had much to do with the government's concern for macroeconomic stability, particularly the adverse impact of substantial capital inflows on the exchange rate, export competitiveness, inflation, and the like. Given the concern, the government preferred gradual liberalization as a way of controlling associated risks and, in particular, intended to use banks as risk managers. As a result, other than domestic banks, liberalization was limited.

Specifically, overseas issuance by domestic firms of foreign currency-denominated bonds was deregulated in 1991. And in January 1992 the Korean stock market was opened to foreign investors. Commercial loans by domestic firms from foreign agents, which had been prohibited since 1986, were allowed in 1995.

Still, explicit quantity restrictions and discretionary or informal controls remained prevalent. For equity investment a 10 percent aggregate ceiling on foreign ownership of listed firms was imposed, which continued until the crisis. With regard to commercial loans by firms, restrictions on the uses of funds existed and government approval was required. Likewise, the overseas issuance by domestic firms of foreign currency-denominated bonds was subject to discretionary quantity control.

Thus most capital flows led by firms or through the stock market were not fully liberalized. Moreover, capital flows in other forms and domestic financial markets other than the stock market remained closed. Exceptions were

Figure 4. Net capital inflows to Korea, 1980–98



trade-related short-term financing and foreign currency borrowings of banks. Various restrictions on deferred import payments and the receipt of advance payments for exports were lifted step by step over the 1990s. For banks no explicit quantity regulations existed on long-term or short-term borrowings in foreign currencies.

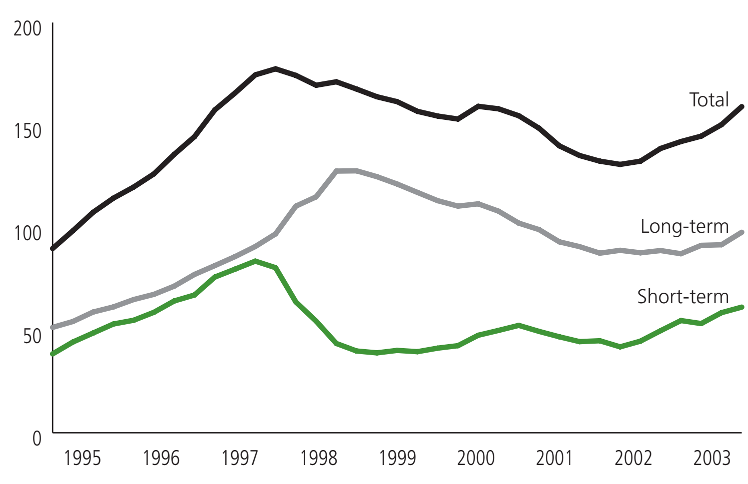
When Korea joined the OECD in 1996, the gradual approach toward capital market liberalization and financial market opening remained intact. To fulfill its obligations as a member of the organization, the Korean government announced a blueprint that would remove barriers to foreign portfolio investment and foreign direct investment—but gradually, over 1998 to 2000.

Lessons from the 1997 crisis. An investment-led boom between 1994 and 1996 generated a strong demand for low-cost capital, while the upgrading of Korea's sovereign credit rating in early 1995 attracted foreign credit suppliers. Combined, these developments led to a sharp surge in net capital inflows. As dictated by the policy stance, debt instruments carried most of the increased capital inflows during these years. Though portfolio investment increased rapidly, stock investment was limited—reflecting the ceiling restrictions mentioned earlier. Consequently, the surge in net capital inflows was tantamount to a sharp increase in Korea's external debt (figure 5), of which a substantial portion was short-term borrowings of banks. In November 1997 foreign creditors ran to claim these short-term borrowings, leading to the crisis.

Given the consequences, some argue that the liberalization sequence was incoherent and crisis-inviting since short-term capital movements were substantially more liberalized than long-term flows. However, though it is true that long-term capital flows were controlled in Korea, it would be an exaggeration to say that short-term flows were liberalized greatly. Neither firms nor banks could sell their short-term debt instruments in domestic currency to foreigners. Only liberalized were trade-related financing of firms and short-term foreign currency borrowings of banks. Moreover, though it is a fact that short-term foreign currency borrowings of banks triggered the crisis, the policy stance in this area cannot be considered a culprit. Short-term transactions of banks are not only difficult but also undesirable to control ex ante because impacts of related operations on balance sheets often matter for days. As such, ex post control or supervision is the right way to address any potential problems.

The crisis may have been caused by the liberalization policy not being supplemented by supervisory and regulatory reforms. While pursuing the bank-centered liberalization policy, the government failed to promptly induce more prudent risk management of banks. A new financial safety net consisting of prudential regulation and supervision and explicit deposit insurance should have been established in line with the liberalization measures. Hence, moral hazard-inducing elements were intact while new risk taking opportunities were provided. Furthermore, the expansion of banks' overseas business aggravated the situation. Based on the reasoning that overseas activities of domestic banks and corporations do not hamper domestic macroeconomic stability and help competitiveness of corporations, overseas business of banks and corporations was encouraged in the mid-1990s. Banks exploited this new opportunity aggressively, leading to large foreign currency liabilities in overseas branches that exceeded the external debts of domestic branches.

Figure 5. Trend and composition of external debts in Korea, 1995–2003
Billion won



Post-crisis development

Capital account liberalization policy took a revolutionary turn after the crisis. As a way of overcoming the crisis, the Korean government decided to pursue full-blown liberalization of the capital account and opening of financial markets, a sharp contrast to the former gradual approach. All types of domestic capital markets, including short-term money markets, were completely opened to foreign investment by the end of 1998. Furthermore, in April 1999 the government abolished the restrictive Foreign Exchange Management Act and replaced it with the Foreign Exchange Transaction Act, changing the regulatory system for capital account transactions from a positive to a negative. As a result all capital account transactions related to the business activities of financial and nonfinancial firms have been liberalized, placing Korea in the ranks of advanced countries in terms of capital market openness.

Market opening and domestic institutions

Domestic institutions interact with market opening in many important ways. Increased import liberalization leads to intensified competition in the domestic market and puts pressure on the government to overhaul economic institutions and policies. The government may also have to respond to possible social dislocations caused by liberalization. The opening of the capital market increases the potential risk of sudden reversals in capital flows and so tends to induce the government to strengthen prudential regulation and adopt sound macroeconomic policies to avoid serious imbalances.

Moreover, as capital account liberalization in a fast-growing economy is likely to result in a huge influx of foreign capital and increase the amount of financial resources relative to profit opportunities, it is essential to have autonomous financial institutions to carry out objective credit analysis and impose discipline on corporate management. Accountable private risk taking, as opposed to public management of private risks, has to be an integral part of institutional reforms designed to improve financial resource allocation and corporate governance. Deregulation without protection is likely to aggravate moral hazard. Therefore, to minimize the risks of globalization, particularly financial liberalization, fundamental governance reform and meaningful privatization should be carried out.

Moreover, as traditional barriers to trade and investment have been progressively dismantled, national institutions tend to be subjected to unprecedented scrutiny by the global community. Globalization increases demands for institutional harmonization, and multinational organizations put pressure on individual governments to adopt global standards in their institutions, affecting resource allocation and governance. These considerations suggest that domestic institutional development should be an essential part of market opening reforms and vice versa.

The progress of Korea's economic development was largely the reflection of Korea's export-driven and state-led development strategy. Although the success of the export-driven development strategy may provide the momentum and impetus for further liberalization, Korea's experience suggests that such trade-liberalization linkages may have limited effects on important institutions, particularly those affecting financial resource allocation and corporate governance. This was particularly so in Korea. Given the long tradition of industrial policy centered on credit allocation by the government, the political economy of institutional reform in the realm of financial resource allocation was extremely complex. Indeed, major reforms in the financial sector and corporate governance were carried out only in the wake of the 1997 crisis.

In the post-crisis period a series of policy measures was implemented to improve corporate governance and protect the property rights of minority shareholders. From 1998, all publicly listed firms were required to have at least one outside director, to promote effective monitoring of management. Institutional investors were no longer required to follow the shadow voting rule. Also, minimum shareholding requirements were significantly reduced for exercising shareholder rights, such as the right to file derivative lawsuits against company executives for mismanagement.

Korea also overhauled the FDI regime and related institutions. The ceiling on foreign equity ownership in the domestic stock market was eliminated in May 1998. Moreover, the government fully liberalized foreign land ownership by amending the Foreigner's Land Acquisition Act in 1998. In November 1998 the Foreign Investment Promotion Act was enacted to replace the Act on Foreign Direct Investment and Foreign Capital Inducement. The new legislation focused on creating an investor-friendly environment by streamlining foreign investment procedures, strengthening investment incentives, and establishing an institutional framework for investor relationship management, such as the "one-stop service". Last but not least, the Foreign Exchange Transaction Act was enacted in April 1999 to liberalize foreign exchange control. These post-crisis developments are expected to enhance market competition and discipline

Benefits and challenges of globalization

Globalization offers benefits but poses challenges. Countries must address both, and in doing so can draw on international institutions.

Benefits of globalization

From a theoretical standpoint, the welfare implications of globalization have yet to be fully investigated, partly because globalization is a multifaceted concept that incorporates a wide spectrum of socioeconomic development and phenomena. It seems to be even more difficult to quantify the benefits and costs of globalization because reliable measures of economic and social changes induced by globalization are not readily available, nor are the direct effects of globalization easily pinned down due to the inherent endogeneity of such changes.

Nevertheless, some indirect evidence of the benefits of globalization can be constructed if the scope of the discussion is narrowed down to the growth effect of globalization. The growing literature on economic growth has attempted to identify the sources of long-run growth within the framework of growth accounting as well as causality regressions. Among many explanatory variables for economic growth explored in the literature, the degree of economic openness and the quality of institutions seem to be of particular relevance for the discussion of the benefits of globalization as they are the first things to be affected by globalization.

Indeed, a cross-country study for 78 countries by Hahn and Kim (1999) shows that the degree of economic openness and the quality of institutions are the most important factors explaining regional differences in economic growth over 1960–89. Specifically, these two factors together provided East Asia with additional growth of more than 1 percentage point a year (about 35 percent of the predicted growth differences) compared with other developing regions over the sample period. Once the effect of economic openness on the quality of institutions is controlled, the total growth effect of the economic openness variable turned out to be the most important variable explaining growth differences between East Asia and other developing regions, up to almost 1 percent a year. Although desirable, a separate account of the benefits of capital market opening for Korea seems to be premature at this time given the limited availability of data for the post-crisis period.

Challenges of globalization

Korea's 1997 crisis indicates the enormity of challenges posed by and risks associated with globalization. Although Korea has experienced minor balance of payments crises from time to time over the course of its economic development, the 1997 crisis was fundamentally different from previous ones in that it was a crisis of the capital account, not the current account. This implies, at least for Korea, that the major challenge of globalization was capital market opening.

In retrospect, the foremost challenge posed by globalization was how to achieve capital account liberalization in an orderly manner. Orderly capital account liberalization requires, in principle, domestic regulatory reforms and institution buildup in advance of capital market opening. But the reality was the opposite.

Pressure by the international community for domestic reform had little effect on domestic reforms given that domestic reform is a sovereign issue whose political economy is quite complex, and that Korea's financial linkage with international market was weak at best before the crisis. Also, deregulation often caused problems in the short run given the absence of proper market mechanisms to substitute for such control. Under these circumstances, reforming prudential regulations and corporate governance—which is crucial for the proper management of potential risks associated with globalization—was not a primary concern.

In view of these challenges, a more practical policy option would be to interweave and coordinate capital account liberalization and ancillary domestic reforms as a single policy package. Such an approach would also increase the likelihood of achieving a positive synergy between capital account liberalization and domestic financial reform. Increased foreign presence in the domestic market could have a positive spillover effect on the practices and institutional framework. The improvements in prudential regulations and corporate governance standards, in turn, may facilitate smooth liberalization of the capital account.

Another challenge worth mentioning was related to labor issues. Import liberalization under WTO initiatives triggered fear among workers, particularly in manufacturing, about negative fallout on their employment status. The combined effect of import liberalization and rigidity in the labor market is likely to be an increase in involuntary unemployment rather than widening wage differentials between skilled and unskilled workers. In addition, increased capital mobility and availability was perceived to have undermined the bargaining power of labor, again threatening job security. These concerns translated into conflicts across segments of society as well as strong market sentiments against globalization—despite the fact that consumers will benefit from increased competition in the market.

Last but not least, the shortage of human capital suited for the new institutional setup and globalized market environment was an obstacle in Korea's globalization. This was particularly the case in the financial sector, which—in contrast to the tradable sector—had been effectively closed to foreign competition until the 1997 crisis. New institutions and a globalized market environment called for a new mindset and business practices, and efficient learning by doing was pivotal. But learning was difficult due to the lack of technical expertise and benchmarks. One resolution to expedite learning would be to import appropriate human capital from abroad, but such an option was largely out of consideration because of its negative implications for domestic employment and negative sentiments against foreign participation in domestic markets.

Role of international institutions

Despite limited human capital resources suited for globalized markets, Korea had been relatively lukewarm about seeking technical assistance for reforms from international institutions. Only after the 1997 crisis did Korea seek technical assistance on financial market opening and related institutional reforms from the IMF and World Bank. But this does not mean that international institutions played little role in Korea's economic reforms. Indeed, pressure by the international community, particularly the OECD and WTO, had great bearing on Korea's pre-crisis reforms, although it fell short of overcoming domestic resistance and inertia to changes.

As noted, Korea's need for technical assistance was largely in the realm of capital account liberalization and related domestic reforms, especially the interpolation of paced progress in prudential regulatory reform and corporate governance. A relevant question is how to ensure that these two processes go hand in hand at a reasonably fast but manageable pace. In practical terms, there is no easy answer.

One possible solution is that multilateral forums on capital account liberalization set binding agreements not simply with respect to the scheduling of market opening, but also to the required ancillary reforms. As for the particulars of the ancillary reforms, international organizations such as the IMF and World Bank could provide technical assistance for developing appropriate standards and rules in developing countries and monitor ex post whether progress is made on time in view of interim targets. In doing so, the pace of market opening and ancillary reforms should be carefully deliberated in a case-by-case manner by incorporating country-specific information, including the politicoeconomic capacity to implement reforms.

Another method for ensuring that liberalizing countries make necessary prudential and corporate governance reforms involves an incentive structure provided by advanced countries, most of which are capital suppliers. This would require first that advanced countries strengthen their regulatory frameworks to be more responsive at the margin to financial risks in borrowing countries. In view of such an assessment by advanced countries, borrowing countries would then have better incentive to initiate domestic reforms and upgrade financial supervision. Such an ex ante incentive structure can be reinforced by ex post measures, including more active involvement by private lenders in the resolution of crises. In this regard, recent discussions on private lenders' bail-in should be translated into a concrete and operational framework.

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Mexico

The episodes of financial distress in several emerging economies over the past few years, and the negative effects on the most vulnerable in society, have generated debate on advantages of globalization. To assess the impact of globalization in Mexico, this study reviews the last 20 years, arguing that globalization has brought substantial benefits since Mexico's insertion into the world economy in the mid-1980s. Even so, globalization has also posed challenges to policymakers and other economic agents. In general, globalization has proven to be a valuable driving force behind designing institutions and formulating sound economic policies. The ongoing process Mexico embarked on more than 15 years ago shows that, to fully profit from globalization, governments must undertake the appropriate economic policies and institutional framework—and develop social safety nets to protect the most vulnerable segments of society.

Market-opening reforms

In the early 1980s the Mexican economy was characterized by debt overhang, lax monetary and fiscal policies, the absence of a competitive industrial and commercial platform, a weak domestic market, and excessive government intervention in the economy. The deterioration of the terms of trade and the reduction in foreign credit worsened this situation. The Mexican economy was heavily regulated and protected from international competition. The balance of payments and public finances were highly dependent on oil-related activities while nonoil exports played a limited role, as most industries produced for the domestic market. The crisis of the early 1980s triggered a major shift from the import substitution industrialization model that had been implemented for decades, to an export-led growth strategy. For this shift, a number of economic reforms were carried out.

The first efforts were targeted to restructuring the public sector. Fiscal policy reform and the divestiture of state-owned assets were two key ingredients of this reform. By 1982 public accounts had substantially deteriorated, and the fiscal deficit reached 16 percent of GDP. Drastic cuts in public spending steadily reduced it from 41 percent of GDP in 1982 to 28 percent of GDP in 1990.

A major privatization program contributed to the referred fiscal consolidation efforts. From 1983 onward, the majority of state-owned companies were privatized, closed, or merged—reducing their number from more than 1,000 at the end of 1982 to roughly 250 in mid-1991. The purpose of this program was threefold. First, it helped bring down the fiscal deficit through the merger and liquidation of unprofitable enterprises. Second, it fostered a more entrepreneurial private sector, which had to take over inefficient state-owned companies and convert them into driving forces in a market-driven economy. Third, it sent a strong signal to domestic and foreign investors about the commitment of the government to structural reform.

The authorities also pursued an ambitious trade liberalization policy. In 1986 Mexico joined the GATT in an effort to stimulate nonoil exports, enhance economic efficiency, and impose pricing discipline to domestic firms. The success of this policy became more evident in the late 1980s, when the nonoil export sector became the driving force of economic growth. Automobiles and computers, together with *maquiladoras* settled under special fiscal programs along the northern border, became the most dynamic sectors of the economy, turning around the composition of exports in Mexico. The share of oil-related products in exports fell from nearly 90 percent in 1982 to 25 percent in 1990 (a decade later it was less than 10 percent).

The consolidation of an export-oriented economy was achieved in the early 1990s through the implementation of preferential trade arrangements. In 1994 Mexico signed the North American Free Trade Agreement (NAFTA) with the United States and Canada, and similar trade arrangements were subsequently pursued with other trading partners, including Bolivia, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Israel, Nicaragua, Venezuela, the European Union, and the European Free Trade Association.

As a result, trade flows increased threefold (from $117 billion in 1993 to more than $326 billion in 2001), and foreign trade doubled its share in the economy (from around 30 percent of GDP in 1991 to around 60 percent in 2001). Since NAFTA's implementation, the Mexican industry has been able to boost its U.S. market shares in leading U.S. import sectors, such as motor vehicles and parts (from 8.7 percent to 15.9 percent), electrical equipment (from 3.0 percent to 17.3 percent), and communications equipment (from 8.2 percent to 22.2 percent).

Another important part of the market-oriented reforms that has shaped the Mexican economy: deregulation, which included dismantling price controls, and liberalizing the foreign investment regime. Price controls had previously been imposed to secure primary goods and services at low and stable prices. Although price controls remained in the 1980s as part of the anti-inflationary programs, the number of price-controlled goods and services was substantially reduced. By the early 1990s a substantial improvement in the balance of payments led to a virtual equalization of the free and controlled exchange rates, and in November 1991 the controlled exchange rate regime, imposed a decade earlier, was abrogated.

Before the 1980s FDI faced very restrictive regulation. But, this changed as the halt in foreign borrowing associated with the debt crisis in 1982 increased external financing needs. Attracting FDI was also seen as a crucial step for stimulating competition and developing a more efficient economy. Following several legal reforms in the 1980s, a new law was enacted in 1993, repealing prior regulations and gradually allowing for up to 100 percent foreign ownership in areas comprising nowadays more than 90 percent of the economic activities accounted for in the national accounts. Accordingly, annual FDI flows steadily expanded from $1.5 billion in 1984 to $4.3 billion in 1993, and up to $24.8 billion in 2001, including the acquisition of Banamex by Citigroup.

The benefits of rapid global economic integration have, however, been unevenly distributed across the country, concentrated primarily in the regions with better infrastructure and closer to the U.S. border, which host most of the *maquiladora* industries established throughout the 1990s. This industry accounts for a large share of the country's exports (48 percent of total exports and 53 percent of manufacturing exports in 2001). The extent to which regions have been able to benefit from the integration with the international economy has also been limited by Mexico's historical pattern of industrialization and urbanization in a handful of cities.

Given the strong relationship between FDI and the growth of exports since the opening of the economy, FDI flows have been distributed unevenly across the country, affecting regional economic growth. Following the regional division established by the *National Development Plan 2001–2006,* Mexico's Central region had 67 percent of $96.2 billion in FDI between 1993 and 2001, followed by the Northeast (19 percent), the Northwest (8 percent) and the Center-West (5 percent). The South-Southeast took barely 1 percent of the flows.

Due to the concentration of FDI in manufacturing and services, the region that benefited most from the opening of the economy was clearly the North, the more urbanized and industrialized one. By contrast, the agriculture-based economies of the South could not expand their exports or attract FDI. Regions more exposed to global economic integration have also shown the most improvement in such social indicators as health and education.

Domestic economic policy reforms

With the stabilization programs, the renegotiation of debt, and the structural changes of the 1980s, Mexico was able to resume growth after nearly a decade of economic stagnation. Between 1988 and 1993, economic growth averaged 3.1 percent a year, while inflation was brought down from three-digits to single-digits, reinforced by a steady decline in the fiscal deficit (from 5.2 percent of GDP in 1989 to 0.7 percent of GDP in 1993). The economy consolidated the shift from an inward- to an outward-looking development strategy. In addition to having a sound export-oriented industry, Mexico gained access to international capital markets following the 1989 foreign public debt renegotiation.

But behind this apparently successful story were factors that eventually led to the 1995 financial crisis. These included the semi-fixed exchange rate, the quick and substantial availability of external capital, current account imbalances, poor institution building, and the cumulative effect of repeated political shocks in 1994. The depth of the crisis, in turn, was influenced by the substantial amount of credit extended by the banking system under such conditions that its collection would have been in doubt even without a crisis.

The banking sector, nationalized in 1982, experienced drastic changes as financial liberalization was pursued after 1988. With controls on interests rates lifted and quantitative controls on credit eliminated, significant financial deepening took place. But, with commercial banks remaining under government control until the early 1990s when credit institutions were privatized, the sector lacked both a professional management structure and a well-developed banking supervision scheme, due in part to the political stature of government-appointed CEOs.

The easing of borrowing and lending regulations in a recently privatized banking sector lacking professional managers and supervisors—coupled with substantial capital inflows and a sharp reduction in the government's financial needs—led to an explosive credit expansion in the early 1990s[1]. With nonperforming loans rising and net indebtedness more burdensome, the Mexican financial system accumulated structural problems that made it particularly vulnerable to the impact of the peso devaluation in December 1994.

For most of the credit expansion period, the exchange rate was kept within a widening but relatively tight band—as part of the government commitment to use it as a nominal anchor. But the sustainability of the exchange rate was severely questioned in late 1994 due to the accumulation of serious imbalances in the current account, caused to a large extent by the credit expansion and lax fiscal policy. And then in 1994 there was a significant increase in interest rates. The reference interest rate rose from 10.8 percent in mid-February to 22.1 percent in mid April, and it remained high, both in nominal and real terms, for the rest of the year. This increase in interest rates posed a monetary policy dilemma. The central bank required high interest rates to defend the semi-fixed exchange rate regime, but was aware of an already battered banking system whose fragility intensified as interest rates remained high.

The inconsistencies created by such dilemma eventually led to the balance of payments and banking crises, aggravated by exogenous shocks throughout 1994, including a substantial rise in the U.S. interest rates and mounting domestic political tensions (including the assassination of a presidential candidate). Together, these elements provided the setting for a steady drain in international reserves, until the exchange rate ceiling had to be abandoned in December 1994. The peso devaluation prompted several damaging effects. Inflation and interest rates skyrocketed. Economic activity collapsed. And the burden of servicing domestic and foreign debt increased.

Along with a strict stabilization program in 1995, including cuts in public expenditure and a tight monetary policy within a newly adopted flexible exchange rate arrangement, the authorities were forced to manage the threat of a systemic banking crisis. It then became clear that successful integration with global financial markets could not be achieved without addressing structural weaknesses in the financial system, including inefficient management, lack of transparency and information disclosure, a poor market discipline and poor credit culture, weak prudential regulation and supervision, and ineffective judicial systems and bankruptcy laws. Implementing a far-reaching reform aimed at developing a sound domestic financial system and a solid regulatory framework—to enable Mexico to cope with a new era of sudden and unanticipated swings in capital flows—became a top policy priority.

A profound restructuring of the banking sector has been under way since early 1995. One of its main components has been the adoption of internationally accepted accounting, capital requirements, and risk managements standards, as well as the creation of a new Institute for Bank Deposit Insurance. Restrictions on FDI were gradually eased, and by 1999 up to 100 percent foreign ownership of commercial banks was allowed.

Simultaneously, the adoption of a floating exchange rate arrangement in late 1994 allowed the exchange rate to adjust to external shocks, reducing the possibilities of speculative attacks, encouraging an increasing preference for longer-term direct investment over portfolio investment, and preventing long-lasting misalignments of the real exchange rate. Moreover, the floating regime in Mexico has allowed the economy to grow, maintaining the current account deficit at sustainable levels and reducing inflation.

The crisis showed the vulnerability to short-term capital flows, and policies were implemented to foster long-term productive investment. The policies included opening new infrastructure sectors to private investment (railroads, ports, airports, satellites) and deepening trade liberalization. Further integration with international capital and trade flows was instrumental for building up a sustainable external sector. Between 1998 and 2001, FDI financed on average 96 percent of the current account deficit, up substantially from 28 percent observed in 1990–94.

Along with a strict fiscal discipline, an active debt management policy has resulted in a steady decline in foreign public debt, reducing the country's vulnerability to short-term capital flows. Recall that one of the underlying factors that exacerbated the magnitude of the 1995 crisis was the accumulation of short-term dollar-indexed government securities. The subsequent partial replacement of external debt by domestic debt has been facilitated by the growth of local institutional investors, such as pension funds, fostered by the 1997 social security reform. Domestic debt strategy has also focused on lengthening the average maturity of the public debt to reduce the vulnerability of public finances to external shocks, while deepening domestic financial markets.

The Central Bank established proper foreign exchange regulations for the banking system. Specifically, regulation now encompasses foreign exchange positions, limits on liabilities denominated or linked to foreign exchange, liquidity coefficients, and information requirements. These regulations improve the ability of individual institutions to face adverse shocks and make the financial systems more capable of handling the volatile capital flows that characterize open and global economies.

The 1995 financial crisis also highlighted the need for a consistent social protection strategy to minimize the consequences of economic shocks and strengthen human capital. Nonpriority investments were delayed, but the expenditures for basic education, health, and other social programs were maintained. There were also specific measures to protect the poor from the heaviest burden of adjustment, including training scholarships to serve as a sort of safety net in the absence of unemployment benefits, direct support for agriculture and livestock activities, and the creation of temporary jobs.

Social policy in Mexico distinguishes between actions geared towards the general population and those targeted for poverty alleviation. The former focus on health care, labor, and social security issues. The latter are based on an integral approach, which include programs for human capital development (including a shift from pure income transfers to transfers conditional on recipients investing in health, education and nutrition), physical capital development, and income generation, such as public works and micro-credit schemes.

The reforms address more efficiently the needs of the population given the rapid changes from economic globalization the demographic features of the population[2].

Acknowledging the North-South disparity, the Mexican authorities are strengthening social safety nets, as well as actions to address chronic poverty. This includes a review of social policy and expenditures involving an assessment of vulnerable groups, risks, and prevention and mitigation measures. Mexico has developed over the past few years a consistent social policy by reducing poverty and enhancing human capital formation through higher and more focused public spending. The policy revolves around six strategic guidelines: increasing budgetary resources for social spending, enhancing the redistributive impact of social spending, targeting spending in poverty alleviation programmes, decentralizing social spending, increasing transparency and accountability, and incorporating regional considerations.

Market opening and institution-building

In the early 1990s the government realized that the reforms launched in the mid-1980s were still insufficient to complete the opening of markets. One of the obstacles to achieve sustainable growth and development had its origins in institutions. Among the symptoms were ill-designed institutions, poorly defined property rights, lack of contract enforcement, high transaction costs, and flawed policies. It was therefore necessary to carry out a series of institutional reforms and modifications in the regulatory framework in different sectors, starting with land ownership, central banking, and economic competition.

Land ownership. In 1992 a reform in land ownership transformed communal (*ejido*) lands. With this reform, the *ejido* land became private property, and property rights were clarified. Through this reform, irregularities in land tenure have been reduced, with property rights respected more, and contracts enforced[3].

Central banking. In 1994 a constitutional reform allowed Mexico's Central Bank to become autonomous and establish price stability as its main objective. The autonomy is based on three features: administrative independence, the power to determine domestic credit, and the creation of a board, whose members serve in overlapped periods and cannot be removed unless they commit a serious fault. This move reflected the acknowledgement of the negative effects of inflation on economic development and the importance of entrusting responsibility for monetary policy to an independent central bank with clearly defined power and objectives.

Competition. The Federal Competition Commission, created in 1993 as a result of a new Federal Law of Economic Competition, has technical and operational independence and is responsible for competition enforcement. It plays a fundamental role in fostering competitive markets through the approval of mergers and acquisitions—and through the prevention, investigation, and elimination of monopolistic practices in all sectors of the economy. Its institutional framework is similar to that of the U.S. Federal Trade Commission. Among its main achievements stands the resolution in December 1997, by which it found that the main telephone company had substantial market power in five relevant markets, paving the way for further action by the sector's regulatory agency[4]. Other examples include actions against anticompetitive collusion promoted by municipal governments and state-owned companies.

The 1995 crisis was a reality check on the efficacy of the institutional reforms instituted in the early 1990s. It showed that reforms had to be more strictly enforced, that they had to respond to a more rapidly changing economy, and that Mexico was already inserted into the globalization process, with all its benefits and challenges. That led to a second generation of reforms.

Following the 1995 banking crisis, the authorities set up a new regulatory and institutional framework for the financial sector, still being consolidated. The new Institute for Bank Deposit Insurance became operational in June 1999, with three main responsibilities: to establish a protection system for banking savings, to conclude the recovery of the banking institutions, and to administer and sell the assets under its charge. Bank savings now have limited coverage, establishing the necessary incentives to instill additional market discipline. In the same spirit of fostering conflict resolution between financial institutions and its customers, the National Commission for the Protection and Defense of Financial Services Users was created in 1999.

In April 2000 a new bankruptcy law and legal framework for granting collateral was enacted, to improve the allocation of business resources and facilitate access to credit. The new legal framework is intended to maintain a balance between firms and their creditors to protect the legal rights of both. Altogether, these legal and institutional changes will maximize the value and viability of a firm in financial distress, establishing a more leveled playing field for addressing financial globalization.

A year later, Congress approved several institutional and regulatory changes to achieve a modern and sound banking sector. Among the most significant is the reformed credit institutions law, which strengthens bank surveillance and supervision by increasing the role of external auditors and introducing prompt corrective actions based on banks' capitalization levels. It also reduces regulatory costs by establishing a clearer definition of financial authorities' responsibilities and avoiding duplication. And it enhances the corporate governance of credit institutions by allowing shareholders to have greater access to information, introducing independent board members, and creating an audit committee at the board level, led by one of the independent board members.

To achieve long-term sustainable growth rates, Mexico needs a mature capital market that can serve as an alternative source of financing, especially when bank credit is tight. For this purpose, an additional overhaul of existing financial legislation was needed. As part of the financial reforms, the securities market law was reformed to strengthen issuers' corporate governance structures, guarantee minority shareholders' rights, and avoid insider trading and market manipulation. In addition, a new mutual fund law was enacted to encourage greater retail participation in the securities market under a better regulated environment, including enhanced minority shareholder protection and greater transparency to avoid conflicts of interests between fund managers, and brokerage houses and banks.

Congress also approved new amendments to the Credit Institutions Law, as well as the Pension System Law and the Organic Laws of the Foreign Trade Bank (*Banco de Comercio Exterior*), the Bank of of National Savings and Financial Services (*Banco del Ahorro Nacional y Servicios Financieros*), and *Nacional Financiera.* These new regulatory framework is designed to strengthen the banking system by introducing independent board members, establishing clear mechanisms to control their impact on aggregate demand, forcing institutions to make periodic public reports, and strengthening technical assistance and support programs.

Congress approved, in addition, changes and additions to the Law of the Retirement Savings Systems, in order to reach, on a voluntary basis, the rest of the economically active population—including independent workers, federal state workers, and workers from public entities, states, and municipalities. With this amendment, individuals can make complementary contributions that can be withdrawn when they reach age 60. One of the most interesting features of this new law is lifting the restriction on buying foreign securities, which allows for greater investment flexibility and diversification. The new investment limit is 20 percent of assets under management of the *Afores* (organizations in charge of managing retirement savings funds). But a temporary limit of 10 percent will apply until Congress reevaluates the subject in April 2003.

Institutional developments in infrastructure, albeit incomplete, were also enhanced after the 1995 crisis. In telecommunications, for instance, the government announced new measures to liberalize the sector while building up a more appropriate institutional and regulatory framework. Note that the privatization of the telephone monopoly, TELMEX, in 1991 was done in the absence of a new law and regulatory framework. As a result, monopolistic practices hampered the sector's development until 1996, when barriers to entry for competitors in long distance and local services began to be dismantled under the responsibility of a new sector-specific regulator—the Federal Telecommunications Commission—and once new legislation was enacted. This experience shed light on the importance of creating a regulatory framework to accompany the privatization effort.

Further attention to institutional and regulatory aspects was required as other infrastructure sectors were opened to private participation. The Energy Regulatory Commission was created in 1995 to oversee the opening of the natural gas industry[5]. Other infrastructure areas opened to private participation (railroads, seaports, and airports) also experienced significant legal and institutional changes[6].

Deregulation of economic activity has also led to institutional changes. To address the issue of high transaction costs due to inefficiencies in government procedures, a new specialized commission—the Federal Commission for Regulatory Improvement—was created in May 2000. It is to revise the national regulatory framework, and make an assessment and propose regulation improvements so that transaction costs are reduced. Its legal mandate is to ensure transparency in drafting federal regulations and to promote cost-effective regulations that produce the greatest benefit for society.

Social security reform entailed a significant institutional and regulatory overhaul as part of broader efforts to tackle the financial viability of the previous pension system. By shifting from a pay-as-you-go system to a fully funded individual capitalization scheme, the reform strengthened the link between contributions and benefits, enhancing overall financial soundness. Within this scheme, the National Commission for the Retirement Savings System, established in 1997, increases transparency and competition among private pension fund managers.

CHALLENGES AND BENEFITS OF GLOBALIZATION

Despite of the high economic and social costs of the 1994 crisis, Mexico deepened its integration with the world economy. It did not retreat. That brought several positive outcomes, but significant challenges remain to benefit fully from the process.

- *Faster and stronger economic recovery.* Unlike the 1982 crisis, when it took the rest of the decade to recover, in 1995 the existing links with the world economy, particularly the U.S. economy, enabled Mexico to reactivate economic growth in a very short period. GDP, after falling 6.2 percent in 1995, grew 5.2 percent the following year, and until 2001 it averaged 4.4 percent. This would not have been possible if Mexico had not developed a strong foreign trade sector. Openness to trade and access to international capital flows made it possible to increase exports fourfold in the 1990s, while drastically shifting from oil-based to manufactured exports.
- *Incentives for sound economic policymaking.* By exposing and punishing economic mismanagement, globalization has contributed to the soundness of domestic economic policies. And within this context in 2000 Mexico secured a presidential transition without economic disruption, for the first time in three decades. The incentives for maintaining responsible domestic economic policies have since proven highly effective, given the ability to attract significant long-term capital inflows under even less favorable external conditions.
- *Appropriate exchange rate arrangements.* The floating exchange rate adopted in 1995 allowed the Mexican economy to grow, while annual inflation was drastically reduced from 52 percent in 1995 to 4.4 percent in 2001, the lowest ever. The exchange rate regime has also been efficient in absorbing large external shocks, limiting short-term capital inflows, and keeping the current account deficit sustainable. It shows that a floating exchange rate can be good for emerging markets.
- *Modern and well-supervised domestic financial systems.* The 1995 crisis exposed with unprecedented fierceness the dangers and risks of having a poorly developed and supervised domestic banking system. Since then, a profound restructuring has put the sector on new footing. But with the task unfinished, globalization poses strong incentives for policymakers to permanently

upgrade financial regulation—to avoid excess risk-taking from financial institutions and to minimize the negative effects of sudden and unexpected capital shifts, a key feature in current global financial markets. This concern stems from the need to promote financial intermediation in less regulated markets, and to maintain the effectiveness and credibility of fiscal and monetary policies.

- *Institutional and regulatory developments.* Along with opening the economy, Mexico made significant institutional changes, including the consolidation of an autonomous central bank, and the creation of new regulatory institutions, ranging from economic competition agencies to specialized regulatory authorities in finance and infrastructure. The pace picked up after the 1995 crisis, as the risks of a new global marketplace were clearly exposed. Despite these improvements, the institution-building is not over and still requires a strong government commitment to adapt institutions to an ever-changing international context—to lower transactions costs and enhance transparency, consistency, and accountability in policymaking. Globalization has thus proven to be a valuable driving force for institutional change in Mexico.
- *Regional convergence.* Globalization can be a powerful tool for developing countries like Mexico to converge with more developed countries in social, economic, and institutional development. But this is far from being a smooth and automatic process. It requires strong policy actions, domestic and international. With the benefits of trade and capital integration concentrated in the central and northern regions, the Mexican government is launching a strategic medium-term program to integrate the southern region, both with the rest of the country and with Central America.
- *Better standards of living.* All the foregoing factors pave the way for improving the living conditions of a large segment of the population. By fostering sound domestic policies to deliver growth, avoid economic and financial crises, and enhance regional convergence, globalization can contribute decisively to improve the overall standards of living. But policymakers still need to address exclusion of a significant portion of the population from globalization, aggravating structural poverty. The challenge is to invest more in human capital so that the population is better equipped for seizing the opportunities of globalization, while reducing the downside effects associated with economic shocks and downturns through appropriate social safety nets.
- *A stronger relationship with international financial institutions.* Mexico has strongly benefited from international financial institutions (IFIs) in coping with the challenges of globalization. In addition to broader measures to improve the international financial architecture, IFIs can support domestic initiatives to plug into the global economy. In Mexico the authorities are convinced that IFIs can help national authorities ensure that financial openness is accompanied by adequately developed financial supervision and regulation. For this reason, Mexico has decided to undertake IMF/World Bank-sponsored initiatives, such as the Financial Sector Assessment Program and several Reports of the Observance of Standards and Codes.

Notes

1. From December 1988 to November 1994 credit from local commercial banks to the private sector rose in real terms by 25 percent a year, while credit card liabilities rose at a rate 31 percent a year, direct credit for consumer durables at 67 percent a year and mortgage loans at 47 percent a year. All these rates of growth are in real terms.

2. Mexico is experiencing a demographic transition. The population pyramid's base has been narrowing during the last years, as the population growth has declined consistently from about 3.5 percent in the 1970s to less than 1.8 percent at present. This demographic transition prompted the reforms of the retirement system in 1992 and 1997.

3. Article 27 of the Constitution was one of the main legacies of the Revolution, and it

was meant to regulate land ownership after the promised agrarian reform. This law allowed communities that were granted land to own the usufruct of the land but not the land itself. The law failed to take into account the diversity of land quality and population density in the different regions of Mexico, hence this form of ownership was not efficient in every region of Mexico and thus became obsolete. More often than not, this land was sold or leased illegally by the *ejido* owners for purposes other than agriculture.

4. The five relevant markets were local telephony, interconnection services, national long distance, international long distance, and resale of international long distance.

5. The 1995 natural gas reform was aimed at allowing private participation in distribution, transportation and storage, while keeping natural gas exploration and production as a state-run monopoly. The mandate of the Energy Regulatory Commission is to promote competition, protect consumers' interests, facilitate an adequate coverage and encourage reliable, stable, and safe supply and provision of services. Its ultimate objective is to achieve the efficient development of the energy sector to benefit industrial, commercial and residential users, by combining the regulation of natural and legal monopolies.

6. Railroads: Privatization began in 1996 and consisted in separating regional assets from railroad services. Currently, all railroad traffic is privately managed and approximately 18,000 kilometers are granted in concession. Ports: Reform and modernization started in 1993. The reform decentralized the port infrastructure and created a new figure (the Integral Port Administration) while pending for privatization. Air transportation: In 1995 a new Airports Law allowed the granting of concessions for the construction and operation of airports. The structural change process involved the integration of four regional groups with 35 terminals. At present, three regions are in the hands of private investors. Only the Mexico City Airport privatization is pending, since a new location has to be decided.

Russia

Russia differs from other G-20 countries in that it was integrated in the system of international trade and financial relations at the time when its entire political and economic system underwent dramatic changes, caused by the country's transition from the administrative-command economy to market economy in the late 1980s and early 1990s.

A major element of market reforms was the liberalization of external economic activity, which was designed to remove the administrative barriers and replace them with market principles in that sphere of the Russian economy. The legal framework for the liberalization of external economic activity was provided by the presidential decree of November 15, 1991, which allowed all resident enterprises, regardless of their ownership, to engage in foreign trade without special registration. The decree meant a virtual end to the state monopoly of foreign trade. As a result the composition of participants of external economic activity has changed, requiring new approaches to regulating foreign trade.

The role of the regulatory and redistribution mechanisms in external economic activity changed dramatically. The lifting of quantitative limits in favor of tariff regulation transformed import tariff from a nominal duty into a major instrument of foreign-trade policy. A switch to convertibility of the ruble on current transactions was, like the liberalization of external economic activity, part of market reforms. Owing to a shortage of goods in the early 1990s, lack of confidence in the domestic financial system and in economic policy, the transition to ruble convertibility caused the exchange rate of the national currency to decrease many times in nominal terms. At the same time, rampant inflation in 1992–94 strengthened the ruble in real terms. These factors had significant effect on the structure of the Russian economy in the transitional period.

As a result of liberalization of external economic activity and the growing role of the market factors of demand and supply, the geographical and commodity structure of the country's foreign trade has been transformed. It should be noted that the commodity structure of Russia's foreign trade still reflects the serious deficiencies that appeared at the early stages of the liberalization of external economic activity in Russia, a result of a profound and drawn-out economic slump and a shortage of productive investment.

Russian exports increased by 56 percent from 1994 to 2000, while imports fell by 11 percent (figure 1). This is a result of the 1998 ruble devaluation and 1999–2000 price dynamics in world commodity and raw materials markets.

Figure 1. Merchandise trade indicators

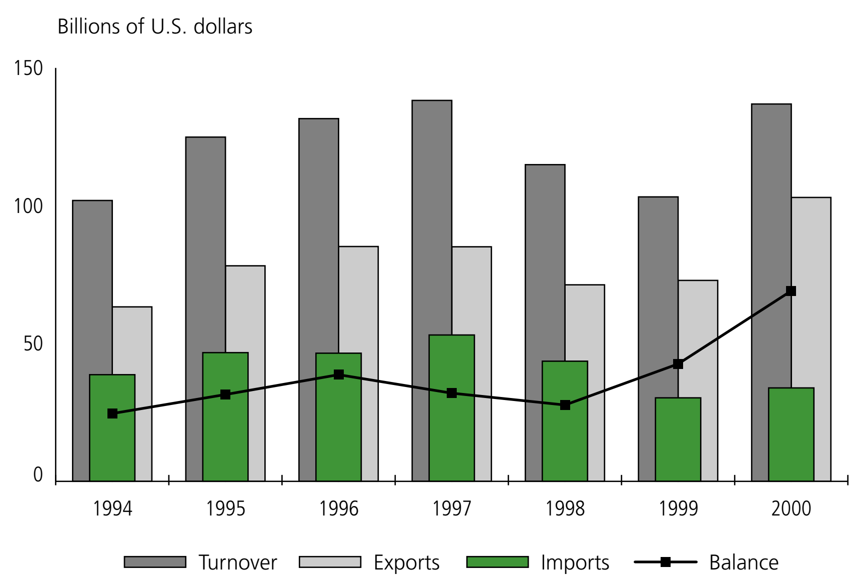


Figure 2. Commodity composition of merchandise exports

The share of mineral raw materials, mostly fuel, expanded from 44 percent of customs-registered commodity exports in 1994 to 54 percent in 2000. This growth shows that the Russian export sector is still oriented to raw materials, making the country's foreign currency reserves and financial condition dependent on world energy markets. More than 30 percent of Russian imports in 2000 were machinery and equipment and 23 percent foodstuffs and agricultural raw materials (figure 2).

The share of countries from the Commonwealth of Independent States (CIS) increased slightly in Russian imports from 1994 to 2000, while the share in Russian exports of non-Commonwealth countries expanded significantly. The EU share in Russian exports in 2000 was unchanged from 1994 at about 35 percent, while the share of eurozone countries expanded a little (figure 3). As the EU share in Russian imports contracted, the share of the United States expanded.

Annual net inflow of foreign direct investment in Russia is small. In 2000 foreign direct investment went mainly to industry (42 percent), transport (21 percent), and trade and public catering (19 percent). The major recipients of FDI in industry were the food and fuel industries. Recent years have seen the expansion of transport's share in FDI and a contraction of the share of the fuel sector. In 1996–98 there was considerable growth in net inflow of foreign portfolio investment in Russia, resulting from the purchase of government securities by nonresidents, but the crisis provoked the ever expanding net repatriation by portfolio investors of capital they had invested in Russia earlier.

Institutional and structural reforms helped create a market economy in Russia, based on private business initiative, free competition, and laws regulating economic activity. The reforms also created the necessary preconditions for greater stability of the Russian economy.

Currently the Russian government conducts budget policy on the principle of a deficit-free federal budget. In 2000–01 consolidated budget revenues of the federal and regional governments exceeded their expenditures. A budget surplus envisaged by the draft federal budget for 2002 will allow the government to use a part of surplus revenues for debt payments and create a financial reserve for future needs.

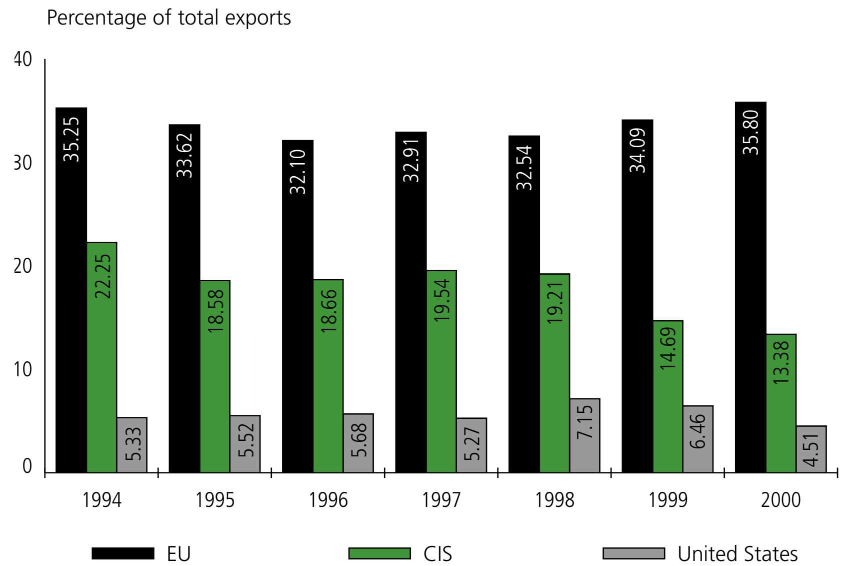
Russia has laid down the foundations for central bank implementation of an independent, transparent, and accountable monetary policy aimed at stabilizing the national currency. Domestic price growth is now many times slower than it was in the early years of the economic reforms. There has been a continuous slowdown in the inflation rate since it peaked in 1998 as a result of ruble devaluation. The real exchange rate of the ruble has until now been lower than in August 1998. The dynamics of the ruble exchange rate have become more predictable under conditions of the floating regime.

Greater stability of the Russian economy and the acceleration of structural reforms increase Russia's opportunities for benefiting from its participation in the global economy. These benefits lie not only in trade. It is also important for Russia to attract foreign capital. An inflow of foreign investment, know-how and technology may help Russia become less dependent on raw materials exports and solve its long-term debt problems.

Liberalization of external economic activity

The measures taken by Russia to liberalize access to its goods, services, and capital markets and, at the same time, liberalize the access of

Figure 3. Major trading counterparty composition of merchandise exports



Russian goods, services, and capital to foreign markets were largely symmetrical. From the outset Russia has adhered to the principle of ruble convertibility on current transactions, consistently removed nontariff restrictions in foreign trade and, whenever possible, lowered foreign trade tariffs. At present Russia has most favored nation trade agreements with most countries. With some countries that hold key positions in the world economy it has agreements on the encouragement and mutual protection of investments, and it is also conducting negotiations on joining the World Trade Organization (WTO).

At the same time, Russia continues to implement foreign exchange regulation and control measures on foreign currency operations related to capital movement. The main condition for gradual liberalization of the foreign exchange operations related to capital movement is macroeconomic and financial stability in Russia and harsher measures to combat the transfer of capital abroad as a means of tax evasion and concealment of illegal income. The Bank of Russia is taking efforts to ease up the requirements of foreign exchange legislation and further liberalization of this legislation.

Foreign trade

In 1992 Russia introduced a uniform procedure for licensing and setting quotas on exports and imports of goods, services, and works by all economic agents. In accordance with that procedure, licenses were granted on the basis of a signed or initialed contract with a foreign counterparty and, depending on the situation, a document confirming the delivery of a commodity within the established quota or a certificate confirming the purchase of an export quota or permission by the corresponding federal agency for the export of specific goods (works, services). The system of export quotas included general quotas on the export of goods, services and works, quotas for government needs, quotas for industrial enterprises, regional quotas and quotas for auction sales.

In 1994 the Russian president issued a decree that abolished export quotas and licensing for all goods and services except oil and petroleum products and also commodities which Russia had to export under intergovernmental agreements. At the same time, Russia cancelled, with few exceptions, all customs privileges, including budgetary provisions for customs duties and benefits granted to the exporters of goods and services for federal government needs. In 1995 export quotas on oil and petroleum products were cancelled. The Federal Law on the State Regulation of Foreign Trade Operations, passed in 1996, included a provision saying that the export of goods, services and works from the Russian Federation and their import to the Russian Federation shall be conducted without any quantitative restrictions (barring exceptional cases).

When quantitative restrictions were lifted, customs tariff became the principal regulator of foreign trade. In 1992 Russia imposed on a temporary basis export customs duties on goods taken out of the country. In 1995–96 export duties on all goods were gradually lifted. In 1999, however, to stabilize the economic situation after the 1998 crisis, increase federal budget revenues, and regulate foreign trade, the government reimposed export duties on goods taken out of Russia beyond the CIS countries, and later beyond the member-countries of the Customs Union (now the Eurasian Community). Import tariffs were lowered all the time they were in effect.

The fact that the number of foreign trade-related requirements made by the International Monetary Fund (IMF) under the Extended Fund Facility arrangement in 1996 were considerably fewer than those made under the Stand-by Arrangement in 1995 and that these requirements only concerned the completion of export liberalization and the lowering of the average weighted import tariff rate should be regarded as the recognition of progress made by Russia in liberalizing foreign trade. There was no requirement to liberalize external economic activity among the conditions set under the Stand-by Arrangement in 1999.

Current foreign exchange transactions

The Russian Federation Law of 1992 "On Foreign Exchange Regulation and Foreign Exchange Control" stipulated that current foreign exchange operations may be conducted by residents without any restrictions. The law allowed residents and nonresidents freely to transfer, bring, and transmit foreign exchange to Russia and also transfer, take out, and transmit from Russia foreign exchange that had been earlier transferred, brought, or transmitted to Russia in compliance with customs rules. By joining Article VIII of the IMF Articles of Agreement in 1996, Russia assumed the obligation not to impose any restrictions on payments and transfers on current operations and refrain from discrimination in its foreign exchange policy.

Russia's foreign exchange legislation requires residents to repatriate their export earnings in foreign currency. To increase the amount of foreign currency in the domestic foreign exchange market, the Russian government requires exporters to sell a part of their foreign currency earnings. Seeking to overcome the aftermath of the August 1998 crisis as soon as possible and stabilize the domestic foreign exchange market, the Russian authorities in 1999 increased the part of foreign currency receipts that the exporters were required to sell from 50–75 percent. The improvement of the macroeconomic situation in the country and the stability of favorable trends in the Russian economy allowed the government in August 2001 to return to the 50 percent requirement.

Capital transactions

Foreign exchange transactions related to capital movement and credit relations between residents and nonresidents are regulated by the Russian Federation Law on Foreign Exchange Regulation and Foreign Exchange Control and Bank of Russia regulations.

Until recently most of the foreign exchange operations related to capital movement were conducted on the basis of Bank of Russia permits. Now this procedure has been expanded to operations such as direct and portfolio investments abroad; payment of title to property which home-country legislation regards as real estate; granting a deferral of payment and delivery for a term of more than 90 days on exports and imports of goods, works, services, and results of intellectual activity; granting by residents, other than credit institutions, financial loans to nonresidents for the term of more than 180 days; and some other operations related to capital flow.

However, for some kinds of foreign exchange operations related to capital movement the Bank of Russia established a simpler registration procedure (when, for example, nonresidents grant residents financial loans for a term of more than 180 days and when residents repay the principal on such loans) and in some cases Bank of Russia permission is not required.

In 1999 resident legal entities were allowed to take without any restrictions foreign exchange from nonresidents as direct investment. In June 2001 Russia liberalized the procedure for resident legal entities making direct investment in CIS countries to the amount of up to $10 million.

In addition, the amendments passed in July 2001 to the Russian Federation Law on Foreign Exchange Regulation and Foreign Exchange Control permitted resident individuals to transfer to and from Russia upon notification a maximum of $75,000 in foreign exchange with the purpose of acquiring title to foreign currency-denominated securities and realizing this right.

As the macroeconomic situation has improved in Russia, the Bank of Russia is considering a possibility of further liberalizing the procedure for taking long-term loans by residents and granting sureties and guarantees in foreign currency connected with the fulfillment of obligations under credit agreements. Plans are afoot to allow resident individuals on a notification basis to open accounts in banks in Financial Action Task Force on Money Laundering member-countries.

Exercising its powers, the Bank of Russia makes a list of Russian issuers' ruble-denominated securities, with which nonresidents may conduct operations using the accounts specially designated for this purpose, determines the range of operations which nonresidents may conduct with Russian issuers' ruble-denominated securities using such accounts and establishes the procedure for opening and keeping nonresidents' ruble accounts.

In 1996 Russia began to make changes in its foreign exchange regulation regime that gave nonresidents access to its primary and secondary government securities markets. In August that year the Bank of Russia established a special procedure for attracting foreign investment to the government securities market, using the ruble C-type accounts specially designed for nonresidents' investment operations. In accordance with that procedure, all operations conducted by nonresidents in the GKO-OFZ market using C-type accounts were conducted through the authorized banks that managed such accounts. The Bank of Russia adopted in 2000 and enforced in 2001 a new instruction establishing the procedure for nonresidents conducting operations with the special C-type accounts, which made it easier for nonresidents to buy foreign exchange with the interest and dividends the holders of these accounts received. The instruction also set the procedure for using the money kept in C-type accounts for making investments in the Russian economy by buying stakes in Russian companies or granting them target loans.

Risk hedging

The futures market in Russia is still in the making. It was adversely impacted by the 1998 crisis. Until 1998 most of the transactions with derivatives had been conducted over the counter. The principal market participants were commercial banks and it is mainly foreign investors that hedged their risks. The basic hedging tools in the over-the-counter futures market were forward currency deals, exchange rate swaps, exchange rate options (these made up a small portion of the market), currency swaps (these also played a minor role), and share options (most of these were bank contracts with nonbank financial institutions). Derivative trade was rudimentary: the underlying derivative assets were interest rates and credit instruments.

As nonresidents were given bigger access to the Russian securities market in 1996, a compensation mechanism was created for the conversion of currencies related to nonresident investments in the GKO-OFZ market. An authorized bank would transact a spot deal, buying foreign exchange from a nonresident, and then conducted a reverse (compensation) spot deal with the Bank of Russia to guarantee the timely execution by the authorized bank of its obligations to the nonresident in buying GKO-OFZ bonds. While transacting a spot deal to buy foreign exchange from a nonresident, the authorized bank concluded a forward deal with him to sell foreign exchange, which like a spot transaction was covered by a compensation forward deal with the Bank of Russia to buy foreign exchange.

As the conduct of each compensation spot transaction by the Bank of Russia to buy foreign exchange from an authorized bank increased Russia's international reserves by the corresponding amount, the conclusion of a compensation forward contract guaranteed the authorized bank the fulfillment of its obligations on forward deals with nonresidents. The exchange rate of the forward deals was calculated on the basis of an estimated level of currency yields of operations in the GKO-OFZ market, which was a curb on the maximum level of yields. Limits were also set on the maximum monthly amount of nonresident investments and the minimum period after which nonresidents could withdraw their money from the GKO-OFZ market. From May 1997 to January 1998, Russia, guided by the obligations it assumed under Article VIII of the IMF Articles of Agreement, gradually lifted all the aforementioned restrictions.

A special characteristic of derivatives exchange market development in Russia is that standard contracts in which the underlying assets were foreign exchange and securities appeared there before the contracts for commodities, although organized commodity markets began to operate as early as 1990–92. This specific reflected market participants' desire to hedge, above all, profits and losses, which depended on the exchange rate dynamics of the ruble against the U.S. dollar.

In October 1992, the Moscow Commodity Exchange conducted the first trading session in currency futures based on the ruble rate against the dollar. In addition to the Moscow Commodity Exchange, the Moscow Central Stock Exchange became a major trading floor, while the Russian Commodity and Raw Materials Exchange was the leading trader in government securities futures. In 1994 the Moscow Commodity Exchange conducted the first trading in commodity futures, in which the underlying assets were wheat and granulated sugar. From 1996 trade in U.S. dollar futures and later in futures contracts for government and corporate securities has been conducted on the Moscow Interbank Currency Exchange (MICEX). In April 1998 trade in ruble-dollar futures began on the Chicago Exchange.

The 1998 crisis had a devastating effect on the Russian futures market. The decision taken by the Russian government and Central Bank to suspend operations connected with resident payments to nonresidents affected Russian banks' settlements with foreign participants in forward deals. The losses incurred by foreign exchange sellers on forward contracts, caused by a sharp fall of the exchange rate of the ruble, and the worsened financial condition of Russian banks created an acute problem of nonpayments on earlier contracts. Market trade in underlying assets contracted significantly and eventually operations in the exchange and over-the-counter derivatives markets were suspended.

After the crisis Russia's futures market began gradually to recover. Market turnovers expanded, the number of market participants grew, the volume of open forward positions increased and the range of market instruments broadened. However, the post-crisis recovery of the derivatives market is slower than the recovery of other segments of the Russian financial market. A major role in accelerating this process may be played by enhanced government regulation of the standard instruments market and the development of an appropriate legal framework ensuring its functioning. This is an important condition of growth in the number of participants who are interested above all in risk hedging.

Foreign investment regulation

Apart from some rules aimed at protecting the national financial system at the early stages of its development, Russia has not used any restrictive measures with regard to foreign investment inflow.

The Federal Law on Foreign Investment in the Russian Federation, which has been in force since 1999, provides state guarantees of the rights of foreign investors making investments in Russia for commercial purposes except capital investments in banks and other credit institutions and insurance companies. The guarantees granted to foreign investors are the same as those granted to their Russian counterparts.

The relations involved in making foreign capital investment in banks and other credit institutions and insurance companies are regulated by the Federal Law on Banks and Banking Activities and Federal Law on Insurance in the Russian Federation. These laws impose restrictions on foreign capital participation in the Russian banking system and on the sphere of activity of insurance companies with foreign interest and insurance companies that are subsidiary to foreign investors, which are necessary at the current stage of development of the Russian financial services market. Nonresidents have to apply for permission to acquire a stake or increase their interest in credit institutions or insurance companies.

Foreign exchange regulation results

Foreign exchange regulation and foreign exchange control by the Bank of Russia aim above all at reducing capital outflow and preventing the legalization and export of the proceeds from crime. Here are some of the facts on the effect of foreign exchange regulation in Russia. According to balance of payments data, the amount of export earnings that was not repatriated and the sum of import advances that were not repaid in time in 1999–2000 was at a 10-year low of 4 percent of total foreign trade turnover. Estimates show that in 1992–93 almost half of all export earnings was not repatriated.

Domestic economic policy reforms

Institutional and structural reforms in Russia encompassed the entire spectrum of economic relations in the period when the country switched to market economics. The outcome was not absolutely positive in all cases. For example, the transfer of state enterprises to private owners, implemented in the form of large-scale privatization, did not everywhere create the necessary incentives for reorganizing enterprises or enhancing their efficiency. Nevertheless, these reforms helped create a market economy in Russia, developed the preconditions for greater economic stability and involved Russia deeper in processes of globalization.

Institutional and structural reforms

During the last decade the fundamental institutional and structural reforms were implemented in the Russian Federation. In addition to guaranteeing private property and free business activity, these reforms ended the state regulation of prices and salaries, abolished the state monopoly of foreign trade and made the ruble convertible on current transactions. For all the deficiencies of the mass privatization program implemented in Russia in 1994–95, it fulfilled the task of transferring enterprises to market relations. In 1991 Russia passed the Law on Competition and the Restriction of Monopoly Activities in the Commodity Markets and in 1999 the Federal Law on the Protection of Competition in the Financial Services Market came into force. The 1998 Federal Law on Insolvency (Bankruptcy) established grounds for declaring a debtor insolvent (a debtor declaring his insolvency) and set the procedure (conditions) for implementing bankruptcy-preventing measures, appointing outside management and regulating other relations arising in connection with the debtor's insolvency. This law applies to all legal entities that have the status of commercial organizations (except government-owned enterprises), noncommercial institutions, consumers' cooperatives, charities, and other foundations. The specific application of this law to credit institutions and other relations connected with the insolvency of credit institutions are regulated by the 1999 Federal Law on the Insolvency (Bankruptcy) of Credit Institutions.

In the early years of the reform a chronic budget deficit was observed, as the budget and tax systems remained largely the product of the redistribution mechanism of the planned economy. The principal systemic problem of the Russian budget was an imbalance between expenditure commitments and revenue collection framework. The major steps taken to overhaul the budget and tax systems were the termination since 1995 by the Bank of Russia providing direct credits to the government, the creation of new fiscal institutions such as the Ministry of Taxes and Duties and Tax Police and the adoption of the Budget and Tax Codes, especially the Tax Code provisions on federal value added tax, income tax, a single social tax and excise duties.

Economic growth in 1999–2001 helped to resolve the budget deficit problem, but this achievement cannot be regarded as a permanent basis for tackling such long-term problems as the reduction of the foreign debt burden unless further reforms are implemented in the budget system and the economy as a whole. The strategic budget policy priority of Russia is the effective and fair taxation of natural resources and real estate, a consistent reduction of taxes on nonrental incomes and the final abolition of turnover tax. A major element of the reform strategy is the transformation of the pension system. As for the envisaged institutional and structural reforms in the economy, particular importance is attached to reorganization of the natural monopolies, comprehensive reform of the social safety, reform of fiscal system and the banking sector, healthcare and education systems, the adoption of new labor legislation, guarantees of the right to private ownership of the land and reform of the judiciary. A key direction of the industrial structural policy is the transformation of the automobile, machine-building, aerospace, and shipbuilding industries.

As a result of the implementation of economic reform and liberalization of external economic activity, Russia saturated its domestic consumer market with goods and services, improved in quality and more varied. The number of private enterprises increased sharply, their share in enterprises of all forms of ownership expanded. Competition appeared, especially in the sphere of small businesses. The number of jobs in the private sector of the economy rose.

The number of the unprofitable enterprises in the Russian economy still remains significant enough despite of some reduction. Moreover the share of the overdue debt in the total amount of accounts payable of the nonfinancial enterprises and organizations is still rather high. Innovative activity of the enterprises remains insufficient. Overcoming of these problems requires further structural reforms in the economy and strengthening the procedure of law enforcement.

Budget policy

One of the fundamental principles of the Russian budget system is to ensure a balanced budget. This means that the amount of projected budget expenditures must correspond to the total amount of budget revenues.

The four new sections of the Tax Code that came into effect in 2001 expanded the taxable base of the value-added tax (VAT), cancelled some unjustified VAT benefits, established the country of destination principle in levying VAT and excise duties on nonenergy products and services, and introduced a flat personal income rate and a flat social tax (premium), which is designed to raise funds for the exercise of citizens' right to state pension and social security and medical care.

The current fiscal policy priorities are to strike out the federal budget expenditure obligations for which there are no sources of financing and ensure the passage of a Tax Code section on profit tax, which would provide for the possibility of deducting all justified production costs, deferring losses for a 10-year period and gradually canceling tax benefits and exemptions. The draft federal budget for 2002 materialized the idea of using budget surplus funds to create a financial reserve (figure 4). This change has been introduced in response to the Russian president's proposal for creating a two-part budget, one designed to meet the government obligations and the other based on revenues received thanks to a favorable foreign trade situation. The latter should be regarded as a strategic reserve.

Monetary policy

Under the Russian Constitution, the Bank of Russia is an independent body guided in its activities by the 1990 Federal Law on the Central Bank of the Russian Federation (Bank of Russia) in its 1995 version with subsequent changes and amendments. This law stipulates that the main objectives of the Bank of Russia are to protect the ruble and guarantee its stability, including its purchasing power and exchange rate against foreign currencies, to develop and strengthen the banking system, and to ensure the effective and smooth functioning of the settlement system.

The ultimate goal of the monetary policy is to reduce inflation to a level that would create conditions conducive to sustainable economic growth (figure 5). The monetary policy is implemented in the conditions of a floating exchange rate regime, which is designed to make the ruble rate correspond to the economic fundamentals and to keep up the country's international reserves at a level commensurate with the changing economic situation. Control over the money supply remains a major means of guaranteeing external and internal stability of the ruble. The immediate objective of the monetary policy is the dynamics of the monetary base. The operational procedure is based on control over net international reserves and net internal assets of the monetary authorities, which the Bank of Russia implements using all the tools at its disposal.

Since 2001 in formulation of monetary policy the Bank of Russia applies elements of inflation targeting. Russia's monetary policy in 2002 will also be based on two key principles: using some elements of inflation targeting and employing the M2 aggregate of money supply as an intermediate target.

Now in conditions of the strong balance of payments the following basic monetary policy instruments are used: the deposit operations with commercial banks to sterilize of excess liquidity, interest rates on Bank of Russia operations, refinancing of banks, and open market operations. The efforts made by the Bank of Russia aim at building a flexible system of monetary policy instruments corresponding to the changing macroeconomic environment. It is also important to create favorable conditions for interbank lending market activity, restore confidence in government securities and strengthen on this basis a major sector of the financial market such as the government debt market. Work is underway to design a mechanism to refinance banks using promissory notes, rights of claims under credit agreements, and mortgages as collateral.

Exchange rate policy

The exchange rate policy pursued by the Bank of Russia in accordance with its legislated purposes and functions is designed to protect the ruble and guarantee its stability. The Bank of Russia is guided by the need for the exchange rate of the ruble to correspond to the economic fundamentals.

In July 1992 Russia introduced the procedure for setting a single exchange rate of the ruble against foreign currencies on the basis of the results of foreign exchange trading on the MICEX. The Bank of Russia regulated the demand for foreign exchange and its supply in the exchange interbank currency market in the economic interests of the country, without setting quantitative targets for exchange rate dynamics.

In July 1995 the Bank of Russia began to peg the ruble to the U.S. dollar, a policy which was initially implemented by setting limits on market exchange rate fluctuations. In July 1996 a new procedure for setting the official rate was introduced in order to enhance the stability of the foreign exchange market and protect domestic producers and household savings. In accordance with that procedure the official ruble rate was set on the basis of daily Bank of Russia quotations, while the pegging of the ruble to the dollar took the form of limits set on rate fluctuations, which provided for a smooth and predictable slide of the exchange rate.

In January 1998 the Bank of Russia started to set a central exchange rate of the ruble against the dollar for a three-year period, allowing the market rate to sway by 15 percent

Figure 4. Balance of consolidated government budget

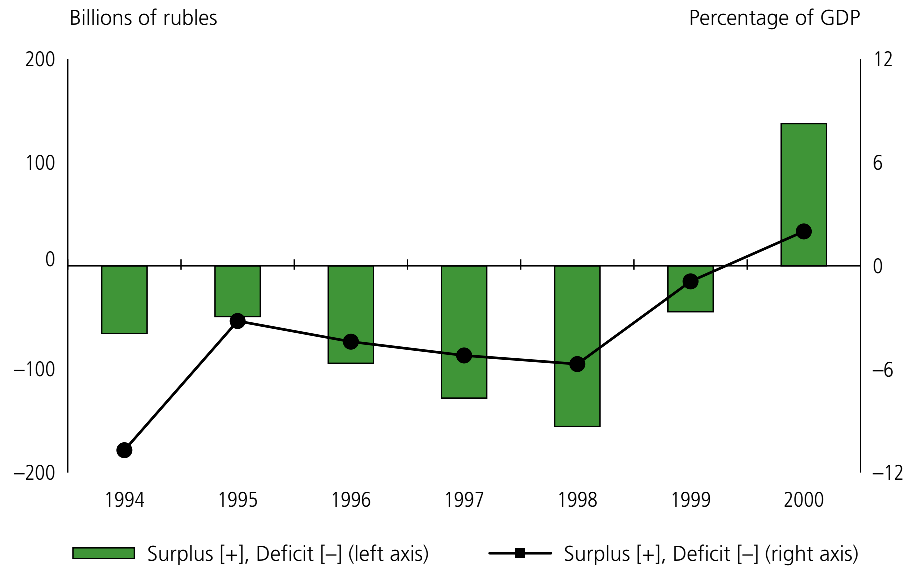
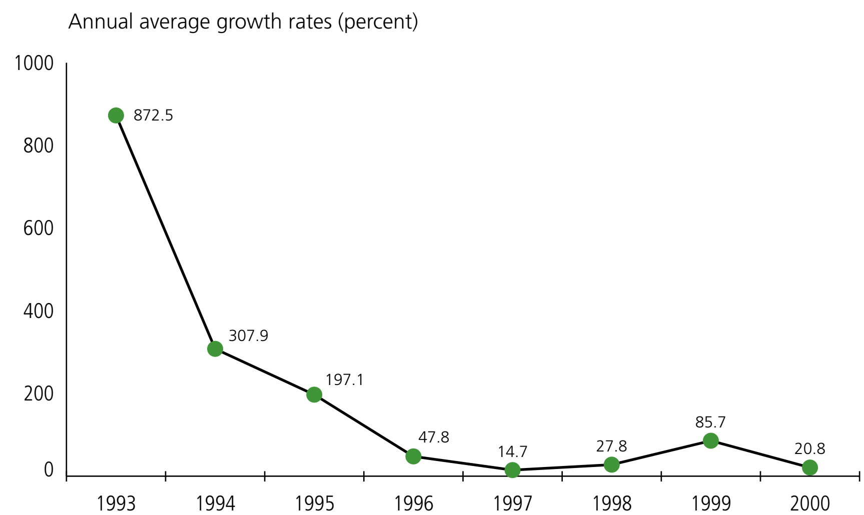


Figure 5. CPI growth rates



both ways. The financial crisis in Southeast Asia and interconnected outflow of nonresidents' funds from the Russian financial market in conditions of high borrowing requirements of the government, along with the Russian current account surplus decline, have resulted in significant pressure on the ruble and sharp reduction of official international reserves in the third quarter of 1998. In that situation the Bank of Russia in August 1998 took the decision to switch to a floating exchange rate regime.

Under this regime efforts were focused on smoothing sharp fluctuations of the exchange rate and replenishing international reserves. To reduce speculative pressure on the ruble exchange rate and smooth its sharp fluctuations, the Bank of Russia uses such exchange rate and monetary policy tools as currency interventions, deposit operations with credit institutions, and, in exceptional cases, changes in reserve requirements.

Banking system

The main principles guiding the activities of credit institutions in Russia and the list of banking operations are laid down in the 1990 Federal Law on Banks and Banking Activities in its 1996 version with subsequent changes and amendments. According to the Federal Law on the Central Bank of the Russian Federation (Bank of Russia) the Bank of Russia conducts the state registration and licensing of credit institutions; sets minimum authorized capital requirements for credit institutions, capital adequacy and liquidity ratios, and maximum risk levels; regulates the size of the open position of credit institutions on foreign exchange, interest, and other financial risks; establishes the procedure for creating reserves for high-risk assets and determines their minimum level; and performs other regulatory and supervisory functions.

The passage in 1999 of the Federal Law on Insolvency (Bankruptcy) of Credit Institutions was a major step forward in converting Russian banking legislation to generally accepted international standards. The law set the procedure for preventing bank bankruptcies, declaring credit institutions insolvent, and initiating bankruptcy proceedings against them.

Implementing anti-crisis measures and the first stage of the post-crisis restructuring of the banking system (September 1998–99), the Russian government and Central Bank accomplished on the whole the tasks set in their joint document "On Measures to Restructure the Banking System of the Russian Federation", adopted in November 1998. In 1999 Russian lawmakers passed the Federal Law on the Restructuring of Credit Institutions. Drawing on the world practice of restoring banking systems and guided by the Federal Law on the Restructuring of Credit Institutions, the Russian authorities created the Agency for Restructuring Credit Organisations (ARCO).

The efforts made by the executive and legislative branches of power, the Bank of Russia, ARCO, and credit institutions prevented a crisis of the system of payments and a systemic banking crisis and led to the creation of a legislative and organizational framework for the restructuring of credit institutions. Thanks to them, Russia had overcome the most damaging after-effects of the financial crisis of 1998, preserved the viable core of the banking system and helped banks resume providing basic services to the economy. The amendments passed in June 2001 to the laws regulating credit institutions created additional favorable conditions for the banking sector reform. As a result, today Russia has a market-oriented albeit insufficiently advanced banking sector, and some of the banking laws and regulations closely match international standards. Late in September 2001 the Bank of Russia and the government intend to adopt a joint strategy of banking sector development.

The strategic purposes, practical tasks, and conditions of effective reforming of the Russian banking sector during the coming five-year period were formulated in the document "Joint Strategy of Development of Banking Sector of the Russian Federation" prepared by the government of the Russian Federation and the Bank of Russia. The strategic objectives are to increase the banking sector's stability to a level that would preclude the possibility of an outbreak of systemic banking crises, ensure that the banking sector improves its performance in accumulating household and corporate savings and transforming them into loans and investments, restore and strengthen trust of domestic and foreign investors and depositors, especially individual depositors, in the Russian banking sector, prevent the use of the banking system for unfair commercial practices, and further upgrade the governance of state-owned banks.

The major result of the banking sector reform during the coming five-year period should be essential increase of its reliability. Increase of an intermediary role of banking sector in the Russian economy and gradual approach of the Russian banking sector's parameters to parameters of banking systems of countries leading in economic results among the group of emerging market economies are also expected.

Labor relations

A major step towards revamping the system of labor relations in accordance with market principles in Russia was guaranteeing citizens the constitutional right to the free realization of their work abilities and free choice of an occupation. The main reforms of labor legislation expanded the sphere of labor relations regulated by law taking into account the existence of different forms of property ownership. They also allowed citizens to realize the constitutional principle of freedom of work and equal job opportunities, recognized international standards and treaties on labor relations as an independent source of Russia's law, developed the principle of social partnership on the basis of collective agreement, limited the term of labor contracts, required concluding labor contracts in writing, allowed employers to dismiss workers for violation of labor discipline without consent of the local trade union, guaranteed trade unions the right to demand punishment for executives who violated trade union laws or the terms and conditions of collective agreement, granted recognition to the unemployed status, and provided social security guarantees to the unemployed.

However, the applicable labor legislation, whose fundamental principles were laid down in 1971, remained archaic for the most part, divorced from the civil legislation based on market principles and encouraging illegal practices. At present the lower house of Russian parliament, the State Duma, is considering the draft of a new Labour Code, containing provisions on social partnership, the representation of workers and employers, the regulation of social and labor relations on a collective basis through negotiation, easing up the procedure for terminating labor contract, and the practice of combining several jobs at one workplace. The aim of the new labor law is to ensure the effective protection of workers' rights and interests, legalize salary incomes, stimulate workforce mobility, and facilitate the implementation of structural changes at enterprises. In the middle term measures are to be taken to formulate the principles and create the organizational basis of a wage rate regulation system as part of the social partnership system, which would take into account the differences in the complexity of the work done and the qualification of workers. Steps will be taken to improve the system of compulsory insurance against accidents at work and occupational diseases.

Social safety network

Under Section 2 of the Tax Code of the Russian Federation the employers who make payments to hired workers, as well as individual entrepreneurs, tribal and family communities of the small peoples of the North engaged in traditional businesses, farm managers, and lawyers should pay a flat social tax, which is levied, depending on the category of taxpayer, on payments and other remuneration paid by employers to their workers in all cases or incomes derived from entrepreneurial or other professional activities minus the expenses involved in obtaining these incomes. The aim of a flat social tax is to raise funds for the exercise of citizens' right to state pension and social security and medical care. The tax will go to the following state extra-budgetary funds: the Pension Fund, the Social Insurance Fund, and the Compulsory Medical Insurance Funds.

The Federal Law on Employment in the Russian Federation, passed in 1991, guaranteed the unemployed benefits and stipends for the period of vocational retraining, provided for the possibility of participating in public works, and mandated the compensation of expenses to persons who have voluntarily changed their place of residence at the proposal of the employment services. The government took steps to assist employment amid massive layoffs and organize the training of the unemployed in the fundamentals of business, but its efforts produced little effect as there was no money in the budget to finance these programs, enterprises needed fewer workers as a result of structural changes in the economy and production decline, there were significant income differences between different territories, people had no money to start up a business, and many small businesses were controlled by crime. The government's middle-term program for the labor market includes measures to cushion the effect of mass redundancies by organizing consultations on employment possibilities for workers slated for dismissal, improve the system of dissemination of information on vacancies in order to cut the time jobseekers take to find new employment, increase the social status of public works, change the entitlements and procedure for paying unemployment benefits, and provide vocational guidance to unemployed and young people before they have reached employable age.

People who have found themselves in a difficult situation and people who are unable to take care of themselves and need constant or temporary social care are guaranteed the right to social protection in the form of financial aid and free social, medical, psychological, and legal assistance mainly from the budget-financed government network of social services. The level of social safety provided by the government social services was low in Russia because the federal and regional governments did not have enough money in their budgets to meet all the needs of the socially vulnerable population groups, while nongovernmental organizations had no commercial interest in participating in the social safety net. The medium-term program to enhance the effectiveness of social care and improve the quality of social services is based on the principle of directing aid to those who really need it and envisages the development of targeted programs and competitive methods of raising funds for such programs. It also envisages the introduction of a contract system under which a recipient of aid would assume reciprocal obligations (employment, participation in public works), replacing benefits for working people with cash payments, separating and redistributing, if necessary, the powers of different levels of government in the sphere of social support, working out standard requirements for the government social services on the basis of the government social care standards, creating a system of evaluation of the quality of the implementation of social programs, and providing the entire social sphere with information technology.

Education, healthcare, and social policy

The brunt of financing education, healthcare and social policy in Russia is borne by regional governments. The largest share of expenditures on education, health, social policy, culture, the arts, and mass media in the structure of consolidated budget expenditures was registered in 1996–97. In later years this share contracted as growth in all budget expenditures slowed. However, the share of budget expenditures on health and social policy in 1998–2000 was larger than in 1994–95. The share of budget expenditures on education in those periods was practically the same. In 2000 the share of budget expenditures on education, health, culture, the arts, and mass media was 28.5 percent of consolidated budget expenditures compared with 24 percent in 1994. There were several factors that impacted the levels of government spending on education, health, and social policy: on the one hand, the Russian education and healthcare systems became increasingly commercialized; on the other hand, paid services were affordable to a small part of the population. There were no commercial alternatives to the government pension system.

Education is one of the principal areas where Russia intends to enhance the role of economic mechanisms by drawing a more distinct dividing line between the spheres covered by paid and free education, work out national education standards, organize an independent system of certification and quality control of education, and award targeted social grants. In the field of healthcare Russia plans to create a legislative framework for the completion of the transition to the insurance principle of paying for medical aid, which would help eliminate the chronic shortage of funds and guarantee the population basic medical services. The reform of the pension system will be based on the creation of a transparent system of accumulations for old age, depending on one's contribution made during one's working life.

Impact of external factors

Major external factors influencing the Russian economy include the dynamics of world commodity prices and cross-border capital movements.

Influence of the world commodity markets

The dynamics of world energy prices is key to Russian export performance. In the period from 1994 to the first half of 2001 the share of energy products in total Russian exports had constantly expanded. In the last 18 months export dependence on the price of oil and other energy resources has increased. The share of energy resources in total exports in the period of 2000 to the first half of 2001 expanded to 53–55 percent, of which the share of oil amounted to 24–25 percent. It is estimated that a fall in the average price of oil by $1 a barrel leads to the reduction of Russian exports of oil and petroleum products approximately by $1–1.2 billion a year. A fall in the average price of oil in 1998 by $6.50 a barrel compared with 1997 led to a $7.5 billion drop in exports of oil and petroleum products, while a rise of 60 percent, or $10.50 a barrel, in the average price of oil in 2000 ensured more than half of all growth in exports.

Changes in the price of oil affect the dynamics of gas prices with a time lag of three to six months. Natural gas is the second most important Russian export commodity. In 2000 and the first half of 2001 natural gas accounted for 18–20 percent of Russian exports. The 2000 growth in gas exports increased by one-quarter the value of Russian exports apart from oil and petroleum products. As a result, thanks to a price growth in world energy markets in 2000 by more than 64 percent year on year amid the expansion of physical volumes of energy exports by almost 4 percent on average, Russian energy exports increased 70 percent, ensuring three-quarters of increment in total Russian exports.

In 2000 the enterprises of the major exporting industries received more than 70 percent of total profit of the Russian industry. About 21 percent of total fixed capital investments was made by the leading export industry—the fuel industry. The increase of merchandise exports promoted achievement in 2000 of a high current account surplus (more than $46 billion) and growth of official international reserves of Russia (by about $16 billion during the year). Thus, net export proceeds influenced essentially the developments of Russian GDP and in many respects determined foreign exchange and financial positions of Russia. The extent of consumer demand and a level of investment activity also to a considerable degree depend on expenditures of export and adjacent industries.

Influence of capital movements

In 1995 Russia found its economic system largely reformed and its new priority now was economic stability and growth, which could only be achieved by slowing inflation. In that period Russia made the historic decisions to stop financing the budget deficit with Bank of Russia loans and peg the ruble to the U.S. dollar. The development of the government securities market accelerated as a result, and overall these decisions helped reduce inflation many times, facilitating growth in household real income and creating a predictable environment for production and investment. Conditions appeared for an end to decline and the beginning of economic growth in Russia. A rise in investment activity could be achieved in particular by bringing foreign investment to the

Russian economy. Thus the emphasis was made on increase of inflow of portfolio investments that on the other hand however raised vulnerability of economy to possible changes in the foreign capital movement.

In the first quarter of 1996 nonresidents had no legal investments in the GKO-OFZ market, but after they received access to the government securities market, the market value of their GKO-OFZ portfolio in the second quarter was estimated at 6.3 billion rubles and in the fourth quarter it rose to 11.7 billion rubles. In 1997 the foreign investors' share in the government securities market had reached 30 percent. In the second half of the year, however, the situation in the Russian financial market began to deteriorate under the impact of extremely adverse external factors. A series of crises broke out in the Asia-Pacific region, financial markets became destabilized all over the world, and capital started to flee from unsafe countries and regions. Investors distrusted Russia because it failed to resolve its budget deficit and government debt problems while its current account surplus contracted. In the fourth quarter of 1997 the nonresident share in the government securities market decreased and the first quarter of 1998 saw the market value of the nonresident GKO-OFZ portfolio decline in absolute terms. Faced with the difficulty of refinancing its debt obligations, the government had to agree to shorter borrowing terms. A fall in the demand for government securities and a sharp rise in the demand for foreign exchange in 1998 provoked a profound financial crisis in Russia, which devalued the ruble many times over, caused a precipitous decline in production and household income.

In 2000 and 2001 external factors for the most part had a favorable effect on the Russian economy as Asian countries were quickly recovering from the crisis, international trade boomed, and energy prices soared. However, as prospects for the future of the foreign-trade sector of the Russian economy, especially the dynamics of prices of major Russian exports, remained unclear during this period, there was always a possibility of deviation of a number of key parameters from the macroeconomic forecasts laid at the basis of the country's economic policy.

Liberalization and institutional development

Unlike other G-20 countries, Russia had only the last decade to engage in institutional development in accordance with the principles of market economy. Throughout the period of economic reforms Russia worked towards creating a legal and institutional environment for market economy, legalizing multiple forms of property ownership, building a market-based pricing and wage systems, revising the principles of conducting foreign trade, affirming the independent status of the central bank, instituting bankruptcy procedures and anti-trust regulation, encouraging competition, regulating the natural monopolies and securities market, upgrading accounting standards, and taking other measures. However, the application of the laws designed to regulate market-based economic relations was in many cases inadequate to ensure the achievement of the goals set, and this was one of the factors that imparted negative characteristics to the investment and business climate in Russia. The steps that are being taken now and will be taken in the future to ensure the effective operation of the institutions of executive power and reform the Russian judicial system aim at changing the unfavorable situation in this sphere.

Russia has been making big efforts to ensure transparency of the activities of economic agents and regulatory agencies, which it regards as a condition of the successful functioning of a market economy. To bring its practices in this area closer to international standards, Russia was one of the first countries to agree to an IMF evaluation of the Russian practices in the field of transparency and disclosure of information. In 2000–01 Russia held consultations with the IMF to agree on the country's compliance with the code of good practices in the field of transparency of monetary and financial policy and international standards of dissemination of information. In 2000 Russia agreed for the first time to the publication of the IMF report on consultations held with Russia in 2000 within the framework of Article IV of the IMF Articles of Agreement.

The Bank of Russia also has worked consistently within the limits of its competence towards improving the practice of disclosing information about its monetary policy, banking supervision, and payment systems.

In 2000–01 the Russian authorities drafted the Concept of Banking Sector Development in the Russian Federation and organized its comprehensive discussion, on which basis the document of the government of Russian Federation and the Bank of Russia "Joint Strategy of Development of Banking Sector of the Russian Federation" was prepared, designed for the coming five-year period. Amendments were made to the Federal Law on the Central Bank of the Russian Federation (Bank of Russia), Federal Law on Banks and Banking Activities, and Federal Law on Insolvency (Bankruptcy) of Credit Institutions, which required credit institutions to increase transparency (special emphasis was made on the frequency and contents of reported data) and to compile and publish reports on a consolidated basis, that is, including banks and nonbanking organizations.

In 2001 the Russian government and Central Bank are to work out organizational and legal measures necessary for the complete conversion of banks to international accounting and financial reporting standards and draw up a timetable for lifting the remaining restrictions in order to ensure the conversion from January 1, 2004. The State Duma, the lower house of Russian parliament, is currently considering amendments to the Federal Law on Banks and Banking Activities, granting the Bank of Russia the right to pass to foreign supervisors, on a confidential basis, information it received in supervising banks (excluding statements on customers' operations and accounts) without asking for prior permission from credit institutions concerned and ensuring safety of information received by the Bank of Russia from foreign supervisors on a confidential basis.

The Bank of Russia cooperated with the working group of the Bank for International Settlements Committee on Payment and Settlement Systems (CPSS) on central bank principles, practices, and tasks related to payment systems in drafting the report on the key principles of systemically important payment systems. A study was conducted to evaluate compliance with the key principles by the Bank of Russia payment system and private payment systems. The Bank of Russia wrote and sent to the Bank for International Settlements the first version of the Red Book "Russian Payment Systems", which was compiled in accordance with CPSS recommendations and methodologies. To facilitate data analysis and in connection with the release of the Red Book, the Bank of Russia elaborated and introduced a number of additional reporting forms for credit institutions and its regional branches and announced its guidelines for the reform of the Russian payment system. The Bank of Russia is to build its new payment system in accordance with international standards.

To ensure fuller compliance with the requirements of the Code of Transparency, the Bank of Russia took steps to improve the practice of disseminating information directly related to its own activities. Since 1999 it expanded considerably the contents of the financial statements included in the Bank of Russia's Annual Report, providing additional information on the practice of managing foreign exchange reserves, the state of the Russian payment system, and the improvement of the Bank of Russia efficiency. The Bank of Russia introduced the practice of disclosing its accounting policy, data on capital and assets movement, and detailed comments on individual balance sheet items.

In the Bank of Russia Newsletter, its official publication, the Bank of Russia carried the entire set of prudential banking supervision regulations and began to publish materials relating to the functioning of the payment systems.

The Bank of Russia disseminates information on the established set of indicators in full compliance with the first edition of the Special Data Dissemination Standard (SDDS). Russia's joining the SDDS has been temporarily delayed as the IMF had put forward additional data dissemination requirements (such as data on the country's international reserves and foreign debt). The Bank of Russia has now begun to release information on foreign debt with a breakdown into government debt and the debt owed by the Bank of Russia (on the IMF loan), the banking sector (including the Bank of Russia and Vneshekonombank), and nonfinancial institutions and the types of financial instruments within each sector. In addition, the Bank of Russia has started to release data on the international investment position, which include information on credit institutions, the Central Bank, and Vneshekonombank (previously data were released on credit institutions only). The Bank of Russia website, which contains data compiled in accordance with the SDDS and is accessible to outside users, has been complemented with a description of metadata in Russian and English.

Benefits and challenges of globalization

Russia as a sovereign state with a market economy became integrated with the international economic and financial systems much later than other G-20 countries. By that time many other nations had already passed such stages as growth in international trade in raw materials and the expansion of the exchange of manufacturing industry products and services and were at the stage of creating a global financial market. This circumstance is largely responsible for Russia's current role in international trade and shape of the Russian financial markets' development. Both positive and negative economic developments in Russia in the last decade were attributable to the change of its economic system and this makes the analysis of the consequences of globalization more difficult.

Benefits

The liberalization of external economic activity ended the isolation of Russia's producers of export commodities and consumers of imported goods from the world market. The supply of imported products increased in the domestic market, satiating consumer demand and compelling Russian producers to increase the competitiveness of their goods.

The participation in global economic processes helped Russia build up-to-date institutional foundations of a market-based economic system, such as regulating foreign trade by tariffs, implementing a transparent and responsible monetary policy by the independent central bank, and organizing banking supervision and the payment system in accordance with international standards. Advanced methods of doing business gained ground in the private sector. Among the sources of formation of personal incomes the share of incomes acquired from business activity and the property ownership has increased.

The participation in the system of international exchange brought the key modern technologies to Russia. The use of computers in business and households expanded significantly. The number of individual and corporate Internet users also increased, although in this area Russia is lagging far beyond the industrialized nations: It is estimated that no more than 5 percent of the Russian population use the Internet on a regular basis and 10 percent use it occasionally. The number of mobile telephone users in Russia has risen considerably, and although they still account for 2.5 percent of the population, the mobile phone is becoming increasingly accessible and affordable to different population groups in Russia.

Challenges

The liberalization of external economic activity failed to help Russia overcome its export dependence on raw materials or stimulate the development of the production of high-tech products for export. Competitive imports became one of the causes of production decline in the manufacturing sector of the Russian economy and a rise in open and latent unemployment. Since Russia had no effective and well-financed social security system, that led to a sharp fall in the standard of living of the majority of the country's population.

Structural changes in the economy and a chronic shortage of funds led to a profound crisis of fundamental and applied sciences and provoked a considerable outflow of intellectual resources from Russia.

Direct foreign investment in Russia was too small to have any significant effect on the rates of economic growth or the structure of the Russian economy. A steep rise in foreign portfolio investment in 1996–98 when nonresidents received access to the Russian government securities market was followed by a sharp fall caused by the monetary and financial crisis of 1998.

Russia may overcome these difficulties or at least prevent old problems arising again if it continues to implement institutional and structural reforms, reduces the risk involved in the redistribution of export incomes between sectors, upgrades corporate governance, completes the restructuring of the banking system, improves its social policy, and joins the WTO. It is very important for Russia to convert its system of custom tariffs and custom administration to WTO standards. It is also important for Russia's effective integration with the world economy that its debt problem should be resolved through constructive dialogue with the creditors.

South Africa

The South African economy has opened up significantly since the first democratic elections of 1994. Greater integration has taken place through capital account and trade liberalization, underpinned by a range of domestic policies intended to guide the economy toward structural shifts required to compete internationally—and to minimize the costs of this transition. Greater integration has clearly played a role in turning around the South African economy—average GDP growth from 1994–2000 was 2.7 percent (3.1 percent in 2000), compared with 1 percent in the preceding decade.

This case study outlines South Africa's liberalization process. It describes how the capital account has been liberalized and the management of the macroeconomic effects of capital flows. It deals with trade liberalization and the effects of increased openness on the labor market (a key determinant of poverty). And it describes the coordination of liberalization policies with domestic policies, the economic and social challenges of greater global integration, and South Africa's policy responses to these challenges.

Liberalization of the capital account

South Africa broadly followed the standard approach that current account liberalization should precede that of the capital account—and the prescription that a gradual rather than a "big bang" liberalization may be preferable. At the same time, and somewhat more contentious internationally, this has been accompanied by the early liberalization of controls on nonresidents' capital transactions.

Starting in March 1995 capital account liberalization changed dramatically the scale of international capital flows into and out of South Africa. After almost 10 years of capital outflows, South Africa experienced inward investment averaging around 6.7 percent of GDP a year. These inflows were triggered by a combination of factors: re-entry into the international arena after decades of political isolation, the early abolition of exchange controls on nonresidents, and the strong public commitment to sound fiscal and monetary policy. At the same time, the gradual liberalization of capital controls on residents enabled a substantial diversification of portfolio assets. Outward investment by residents has averaged around 4 percent of GDP a year since 1994.

These general trends were accompanied by marked changes in the characteristics of the components of inflows and outflows, particularly the sources of volatility in the capital account. Prior to political and financial liberalization, short-term lending and currency and deposits were more important in driving the volatility of the financial account (as measured by the standard deviation). From 1995 to 1999, by contrast, portfolio flows became the most significant source of volatility, primarily from the scale of these inflows, not inherent instability[1]. Large-scale, and sometimes speculative, activity by nonresidents in the domestic bond market became the most important source of shocks to the financial account. Investment by nonresidents in South African equities also increased dramatically after 1995 (with a corresponding increase in the impact of equity market volatility on the financial account). But it has been one of the most stable forms of inflow in relative terms: quarterly investment has been consistently positive since 1995. This is in sharp contrast to the more erratic behavior of equity investment in the pre-election period, largely explained by South Africa's subsequent inclusion—and large weighting—in emerging market equity indices.

Access to international capital flows increased the pool of resources available for domestic investment, of particular benefit to the economy, given South Africa's extremely low savings rate of around 15 percent of GDP. It also eased the current account constraint that traditionally limited South African growth. But while inflows have reached levels similar to those experienced in other emerging markets, a number of features distinguish South Africa's experience from that of comparable countries, offsetting the kinds of benefits that faster growing emerging markets have achieved. In some cases this reduced certain risks.

South Africa's capital inflows are significantly skewed toward (unstable) portfolio investment, especially bond flows, and are characterized by disappointing FDI performance. The inward portfolio investment in South Africa in the late 1990s dwarfed that of the other emerging economies, largely a function of the liquidity, depth, and sophistication of South Africa's domestic bond and equity markets. After 1994 there was an exponential increase in foreign participation in the bond market, with purchases and sales of bonds increasing from a monthly average of 15 billion rands a month in 1996 to a peak of 160 billion in July 1998. Investment in the equity market also rose rapidly, with the Johannesburg Stock Exchange experiencing positive flows in every month from the abolition of exchange controls on nonresidents in 1995 to March 2000. While South Africa's capital markets have clearly attracted large flows of portfolio investment, they have not so far proved advantageous in attracting direct investment (as might be expected through their facilitation of takeovers, mergers, and joint ventures).

Direct investment—which tends to be longer term, more stable, and with a greater potential to create jobs and reduce poverty—has been disappointing. Levels increased from 0.1 percent of GDP in 1991–94, to just over 1 percent in 1995–99. Most major FDI flows were privatization related. South Africa's persistently low rates of economic growth clearly provide one important obstacle to FDI. (This would in turn derive from a range of factors—some of them structural factors contributing to adverse macroeconomic conditions, others operating directly on investor sentiment.)

It may be that sound policies require more time to reap benefits. South Africa's experience to some extent mirrors that of Brazil and Mexico in the early 1990s, with large portfolio inflows and little direct investment. (In the latter half of the 1990s, these countries have experienced a shift towards direct investment in the composition of inflows, particularly Brazil.)

South Africa's poor FDI performance may, perversely, be a function of the depth and sophistication of the domestic debt and equity markets. Given the low transaction and information costs entailed in investing in capital markets, investors may have been discouraged from direct investment, with its comparatively higher costs. A developed corporate sector, coupled with a large and relatively liquid equity market, may mean that South Africa is more likely to attract portfolio investors than direct investors, who may find it difficult to break into South Africa's established economic sectors.

Finally, outward investment by South African residents, driven by a desire to diversify globally after years of isolation, has meant that net capital flows in South Africa have generally been lower than in other emerging economies.

Management of capital flows

On the whole, South Africa has participated in international capital markets, while avoiding the downside of instability and crisis, even as the currency has come under pressure in recent years. In part, the authorities took advantage of a number of the structural features of the South African economy. At the same time South African performance was helped by a number of careful policy decisions. This is discussed in more detail below.

First, capital account liberalization was gradual. Exchange controls were abolished for nonresidents in 1995. Removal of exchange controls on South African residents was phased. These reforms focused on institutional investors, the corporate sector, and private individuals. This approach allowed South Africa to restrict the volume of funds and enabled the government to adapt the pace and strategy of liberalization in response to changing circumstances.

Gradualism has not been without its own challenges, particularly managing private sector expectations. From time to time expectations of the announcement of further reforms introduced uncertainties into the foreign exchange market. But, while there was internal and external criticism about the pace of reform, the gradual approach allowed South Africa to avoid policy reversals in the face of currency crises.

Second, South Africa's liberalization process was backed up by supportive and credible fiscal and monetary policy, reducing the scope for domestically generated instability. In particular, reducing the fiscal deficit (and the public sector borrowing requirement) has been a government priority since 1994. The deficit came down from approximately 5 percent in 1994/95 to 1.9 percent in 2000/01; the public sector borrowing requirement has come down from 5.7 percent of GDP to 1.3 percent. With the government's macroeconomic framework in 1996, the Growth Employment and Redistribution Strategy, South Africa both committed to a tougher program of deficit reduction and introduced a medium-term expenditure framework, anchored by further commitment to fiscally sustainable policy. In addition, macro reforms were sequenced with further liberalization. From 1994, for instance, the fiscal position was tightened, while accounting and reporting of contingent liabilities were formalized in 1997.

Third, South Africa reduced a number of important risks through a cautious foreign borrowing strategy, and was largely successful in managing short-term liabilities in the context of low reserves for many years. South Africa's external debt is extremely low by comparison with most emerging markets (March 2001 estimates put external debt at 3.6 percent of GDP, or 8.0 percent of total debt). Its total gross loan debt stands at 44.6 percent of GDP according to March 2001 estimates. South Africa embarked on a process of putting in place a risk management framework to manage risk arising from foreign debt. This entails qualifying risks from exogenous factors and developing a benchmark for optimizing the structure of South Africa's loan portfolio.

Fourth, after experience of the Asian and Latin American crises, South Africa abandoned an implicit real exchange rate target. South Africa had, until then, used the net open forward position as a reasonably effective tool for managing the demand for foreign currency. But, this had costs. To the extent that the rand depreciated at a rate faster than implied by the forward contracts, this intervention led to sizable and unpredictable potential costs to the fiscus. At the same time, the net open forward position was poorly understood by international investors. Perceptions that the entire forward book represented a short-term foreign liability[2] probably put an additional risk premium on South African foreign borrowing. Furthermore, support of exchange rate targets was generally associated with currency speculation, the risks of which government deemed it prudent to avoid.

Fifth, liberalization was accompanied by significant reforms to an already strong financial market infrastructure. Despite repeated episodes of exchange rate pressure and sharp depreciation, South Africa has been protected by a regulatory system that is more established and sophisticated than other emerging markets. The first corporate governance rules were published by the King Commission in 1994. Risk-based capital requirements, in line with the European Union (EU) directives, were introduced for banks in 1991 and for securities firms in 1995. Banks were required to report in terms of the generally accepted accounting rules in 1996. Consolidated accounting rules for financial conglomerates were made mandatory for banking groups in 2000. In rapid succession, minimum international standards were introduced, for capital adequacy, accounting and audit, and disclosure. South Africa is largely or fully compliant with all 12 key financial stability codes and standards, in particular the Basle Accord and the International Organization of Securities Commissions standards.

Sixth, for the banking sector, South Africa's strong regulation, and the structure of the sector, shielded the economy from the transformation of currency crises into banking crises. Many of the vulnerabilities associated with short-term bank flows in other emerging markets have been a product of their impact in poorly regulated and underdeveloped financial sectors, where credit analysis and risk management are weak and bad loans can easily spin out of control in boom periods.

Seventh, while capital outflows by South African residents hurt domestic investment, outflows by South African residents helped the authorities manage the impact of capital inflows. South Africa has not experienced the asset booms that have often occurred in other emerging markets during periods of large net inflows. This has also helped South Africa to lessen the risk of financial crisis due to exchange rate misalignment, as experienced by other emerging economies as a result of sharp exchange rate appreciations.

Eighth, and related to the fiscal policies mentioned above, important tax administration and policy reforms have been coordinated with liberalization policies. The relaxation of exchange controls was accompanied by key income tax reforms to protect the tax base and minimize tax biases that could encourage the export of capital. This focused on the design and implementation of rules to ensure the appropriate taxation of outward investment. Before 1997 the South African income tax was source-based: income tax was levied only on income arising from a South African source. In 1997 "deeming" rules were introduced to bring non-South African sourced passive income (rent, interest, royalties, annuities) accruing to South African residents within the tax base. From January 2001, a full residence-based income tax system was introduced, providing greater security for the income tax base, as South Africa becomes increasingly integrated with the world economy. Transfer pricing and thin capitalization rules are also in place to protect the corporate tax base against profit-shifting by firms investing into or from South Africa.

Managing the macroeconomic impact of capital flows

While South Africa has proved less vulnerable to swings in emerging market sentiment than other emerging economies, the authorities encountered challenges in managing the macroeconomic impact of full participation in the international capital markets. Global capital market volatility occasionally had dramatic effects on interest rates and the exchange rate, requiring difficult policy choices in the context of low growth and pressing social problems.

One of the most important challenges was the vulnerability to financial crisis arising principally from the volatility of portfolio investment—something not readily apparent in annual data[3]. In South Africa's case, portfolio investment is clearly a potential conduit for financial market contagion. Portfolio flows are subject to herding behavior and to sharp reversals that can lead to macroeconomic imbalances, which frequently require painful adjustments. The best defense against this is continued prudent macroeconomic policy.

Second, capital account liberalization, in combination with the constraints in which South Africa set monetary policy in the past, probably hurt South Africa's ability to address structurally high real interest rates[4]. Liberalization, in the presence of an implicit real exchange rate target (to contain inflation and ease the current account constraint that has traditionally dogged South African growth), triggered a shift to high real interest rates of above 10 percent for virtually the entire period from mid-1995 to mid-1999. Financial liberalization has also been an important factor contributing to the decline in personal savings in South Africa since 1980s, as financial sector reforms and innovations during the period made it easier to borrow money to finance consumption, in turn contributing to lower domestic savings and higher real interest rates. These high real interest rates prevented South Africa from moving to a higher growth path and had the effect of attracting large-scale and speculative foreign investment into the domestic bond market. At the same time, periods of significant outflows limited the ability of the Reserve

Bank to reduce interest rates. Inflation targeting is one of South Africa's key approaches to bring down these high real interest rates.

Third, capital account liberalization has potentially severe implications for exchange rate volatility—and the impact on inflation and domestic money market liquidity. So South Africa undertook significant reforms to the monetary policy framework. The changes included a shift in stages from money supply targets to a broad range of intermediate targets, and eventually to a single inflation target. Most important, South Africa abandoned intervention in the forward currency markets, working down a net open forward position of more than $25 billion in 1998 to $4.8 billion in July 2001. Other reforms included a new system for implementing policy, based on daily (soon to become weekly) tenders via repurchase transactions, replacing the previous discount window. Money market liquidity has been managed through this repo market and through capital requirements for banks.

Fourth, fiscal policy also had a role. By reducing the fiscal deficit, the authorities reduce government's contribution to the expansion of domestic liquidity, in offsetting the potentially inflationary increases in liquidity caused by inflows. Fiscal measures were also important in reversing outflows. So fiscal adjustment (or continued sound fiscal policies) was central in restoring macroeconomic balance and signaling the credibility of the government's commitment to doing so.

Trade liberalization

While liberalization of the current account began slowly in the late 1980s, the significant opening of the South African economy began only with accession to the WTO in 1994. South Africa's new tariff program officially took effect in January 1995, and its early adoption by the new government signaled its strong commitment to trade reform. Between 1990 and 2000 the average economywide tariff fell from 28 percent to 6.5 percent, while the average manufacturing tariff was reduced from 30 percent to 6.7 percent. The maximum tariff rate was cut to 61 percent (40 percent excluding "sensitive" countries). The number of tariff lines was cut by a third, and the number of separate tariff "bands" or rates was cut from 200 to 49.

While effective protection has fallen in the aggregate, it has not fallen as fast as the nominal tariff, and has even risen in some sectors. Approximately half of the manufacturing sector exhibits effective protection rates equal to pre-liberalization levels, limiting the effect of tariff liberalization on the anti-export bias.

Although South Africa's trade ratio is still marginally lower than that of other nonoil middle-income countries, the South African economy is relatively open in international terms. The total trade (merchandise exports plus imports) to GDP ratio in 1996 was 40 percent, compared with 46 percent for nonoil middle-income countries. In 2001 it stood at 44 percent, almost doubling over the 1990s.

South African exports, and the net impact of trade on growth, have responded well to opportunities posed by favorable international conditions. Historically, South African exports have shown a high sensitivity to real exchange rates, world demand, and trade policy. Since liberalizing, South Africa's exports of manufactures have risen both in absolute terms and as a share of gross output since the early 1990s, with growth more than doubling from an average annual real rate of 2.6 percent during 1990–94 period to 6.8 percent during 1994–98. To some extent this growth reflects the post-sanctions effect of the return from international isolation.

Although import penetration is high for South Africa (accounting, for instance, for a negative 52 percent of the rise in total output for 1994–98), output growth due to exports has kept pace with the losses due to import penetration. Net trade has accounted for 10 percent of the rise in total gross output between 1993–97. In South Africa's case there is no evidence of dramatic across-the-board declines in domestic market share and no clear pattern between the extent of tariff reduction (or initial tariff level) and the subsequent change in either output or employment. Liberalization has not been de-industrializing.

It would also appear that the net effects of trade on overall employment levels has been marginally positive, with jobs created through exports just outstripping job losses through import penetration.

Complementing trade liberalization, South Africa has pursued the expansion of market access through preferential trade arrangements with industrial countries and the pursuit of regional economic integration. The most important of these are the Trade Development and Cooperation Agreement with the EU, and the recent Southern African Development Community (SADC) free trade agreement.

The SA–EU Agreement on Trade, Development, and Cooperation should improve market access for South African exporters to the EU and increase interregional trade and investment flows. Import tariffs will also decline, reducing the cost of imported inputs and consumer prices. Tariffs on 86 percent of South Africa's industrial exports to the EU are to be fully liberalized on implementation of the agreement. By year six, only 1 percent will be subject to customs duties. The EU's offer on agricultural products is less generous, and only 62 percent of South Africa's agricultural exports are scheduled to enter the EU duty free by 2010. In turn, 89 percent of industrial imports from the EU will be liberalized over a 12-year phase-in period, with 62 percent of the tariff lines reduced to zero on implementation. Tariffs on 81 percent of agricultural imports will be fully liberalized by 2012.

A trade protocol between 11 of the 14 members of the SADC came into force in January 2000. The trade protocol will see 85 percent of trade freed up over eight years and provides for an asymmetrical arrangement for South Africa to open its markets more quickly than other countries. At the same time, supply-side measures were negotiated and implemented to ensure that economic integration goes further than the mere dismantling of tariff barriers—and to integrate productive structures with a view to make them more competitive.

Globalization and policy coordination

Trade reform holds the promise of significant advantages. But it requires effective management of structural adjustment, and must be sufficiently coordinated with other policies. In a narrow sense these policies include supply-side measures to improve export performance. More broadly, trade liberalization—and greater openness to the processes of globalization require the coordination of a range of growth-inducing economy wide policies, from promoting competition, including privatization, to having a package of sound fiscal and monetary policies.

Effective management of structural adjustment requires labor market flexibility, and the appropriate skilling of workers to participate in economic growth. And especially in South Africa, which faces a chronic unemployment problem, provision must be made to ensure broad access for the poor to productive resources—that is, capital and land, usually through small and medium-sized enterprise (SME) development and land reform. Spending on social services—including health and education, and the provision of safety nets for the most vulnerable—underpins long-term human development.

To coordinate the government's Growth, Employment, and Redistribution (GEAR) macroeconomic framework entails a package of supply-side measures to improve export performance. The most important are accelerated depreciation allowances for new manufacturing investment and tax holidays for new approved projects. The government's Motor Industry Development Program, an example of successful supply-side support, has been instrumental in the strong rise in automotive exports, which grew at an annual average rate of 40.6 percent between 1996 and 1999.

In the more general sense, greater openness has been pursued as part of a broad package of policies, set out in the GEAR strategy. In addition to measures related to fiscal policy, public expenditure management, and monetary and exchange rate policy, openness-inducing reforms have been accompanied by programs to restructure state-owned assets, supported by improved competition policy. An expansionary infrastructure program has provided electricity, water, telephones, and houses on a large scale to the poor and previously disadvantaged. There have also been skills development policies and considerable expenditure on health and education.

Even so, the management of structural reforms posed significant challenges to government. Although growth has improved, the economy has shed formal sector unskilled jobs, even as it created jobs in the informal sector and through business services out-sourcing. In addition, demand for high-skilled labor has accelerated dramatically over the past seven years. Overall, therefore, while the composition of total employment has changed, the level of employment has been relatively stable.

To the extent that trade liberalization results in structural adjustment, short-term job losses are inevitable. Ideally, trade liberalization should facilitate rapid structural adjustment so that workers who lose jobs obtain new ones in rapidly expanding industries. Although a number of sectors that experienced sharp reductions in tariffs have also seen increased investment and strong export growth, they do not tend to be the same sectors that use less-skilled labor intensively. Furthermore, they remain small and are unlikely to provide major contributions to employment in the near future.

Evidence suggests that greater openness to trade has induced shifts in production to high-skill, capital-intensive sectors. Absolutely, and compared with other emerging markets, South Africa has a low share of exports that use unskilled labor, and a relatively high share of exports using more skilled labor. All the Asian economies (including a much wealthier Korea) have a higher proportion of unskilled labor-intensive exports. The largest export expansion has occurred in relatively (human and physical) capital-intensive subsectors.

Clearly, part of the challenge of South African labor policy is to increase firm-level productivity, through policies that promote greater skills development. South Africa's policy response has included urgent attention to improving the skills base. The Skills Development Levy is the government's flagship program to enhance productivity through skills development. This is a levy grant scheme for financing education and training, paid by private sector employers through a 1 percent (initially 0.5 percent) levy on private sector remuneration. Employees are in turn entitled to draw on funds of sectoral training authorities to recover approved education and training expenses. The levy raised 1.3 billion rands in 2000/01 and is expected to raise 2.8 billion in 2001/02. Eighty percent of receipts go to the sectoral training authorities, and 20 percent go to a national skills fund to support special training needs and training for the unemployed. The government is also required to spend 1 percent of its payroll on training. Inclusive of all other skills development programes, it expects to allocate 15.5 billion rands to skills development between 2000/01 and 2003/04. Such policies, however, can be expected to operate at a lag.

A further factor contributing to decreasing levels of unskilled employment is likely to be the price of low-skilled labor relative to the cost of capital, the latter having declined over the 1990s due to tax reductions, greater depreciation allowances, and—most recently—lower interest rates. The worsening relative cost facing labor has encouraged firms to substitute skilled labor and capital for unskilled labor. Higher labor productivity has resulted in unit labor costs trending down with inflation.

The challenge facing South Africa is to promote productivity growth in ways that do not undermine the growth of lower wage, lower productivity jobs for unskilled, unemployed people, while at the same time ensuring that the growth of higher-skilled jobs continues apace. In this respect, the government continues with consultations aimed at reforming the labor market, investigating the feasibility of reducing the cost of labor without reducing workers' wages. Trade-supporting programs (such as export processing zones, and duty drawback and rebate schemes) also have the potential to encourage more labor-intensive activities.

Policies to help the poor to gain access to productive resources—capital and land—have an important role in providing incomes to the most vulnerable in the economy. South Africa has programs in place in SME development and land reform.

Support to SME development is provided through supply-side measures targeting enterprise constraints. The mechanisms used for small business support involve institutional and regulatory reforms. Enterprise promotion agencies and wholesale financing companies have been established to act as intermediaries to address SME constraints, such as access to finance and information. Government itself administers programs aimed at increasing SME manufacturers' competitiveness, such as co-financing the acquisition of new technology. Regulatory reforms include, the recent procurement reform with an affirmative small, medium, and micro enterprise participation programs.

SME development has not created jobs on the scale envisaged by the government in its GEAR policy (approximately a third of new jobs by 2000). Studies suggest that only the few, more dynamic SMEs show potential to contribute to rapid employment creation, while survivalist activities (as a result of "enforced self-employment") typify the vast majority of South African SMEs. In part supply-side measures are not sufficient on their own to unleash the employment-creation potential of the SME sector. Research findings consistently show that SME development depends decisively on macroeconomic conditions, industrial and organizational structures, the adaptability of firms, and above all, the capabilities and aspirations of entrepreneurs. The South African SME sector, far from homogenous, would require a fine-tuned set of interventions rather than the generic assistance currently provided.

Some evidence suggests that South Africa may face inherent limitations to the growth of the SME sector. SMEs are likely to show a better performance under more favorable macroeconomic conditions, and with effectively delivered supply-side measures. But research indicates that only a small segment of the entire SME economy has or will develop the capacity to create employment at socially desirable levels. These are generally run by highly educated and experienced entrepreneurs with skilled labor. Given the country's history of dualism and discrimination, strong SMEs and highly skilled labor are unlikely to emerge in substantial numbers from formerly disadvantaged segments of the population, in the near future.

South Africa has also embarked on an ambitious constitutionally driven Land Reform Program, consisting of Redistribution, Restitution, and Tenure Reform Programs. In the five years that the program has been in operation, almost 29,000 households have received 745,000 hectares of land in both redistribution and restitution programs. Many millions more have benefited from protection that affords them tenure security.

The redistribution program helps poor and marginalized communities and individuals get access to land to live on and to farm. The government provides a grant of 16,000 rands per family for the purchase of land and services. Grants are also provided to help communities plan how they are going to use the land and to buy the resources they need to ensure viable and sustainable income-generation enterprises on the land they have bought. The Restitution Program is aimed at restoring land rights and financial compensation to people who were forcibly removed, after 1913, through apartheid and other racially based legislation. So far, however, only 241 of more than 63,000 claims have been settled, these 241 claims involved more than 83,000 beneficiaries. The Tenure Reform Program, to provide land ownership to those (mostly black) people with informal rights on the land on which they live, is being rolled out through a number of consultative processes and legislation.

South Africa's health, education, and welfare policies underpin the economy's prospects for poverty eradication and long-term growth. The social grant system has been the major, and most direct, component of government instruments to ameliorate poverty. South Africa has nine social security grants, with a total uptake of 4.3 million people a month (more than 10 percent of the population). These include an old age grant (a maximum of 570 rands a month, with an uptake of 1.8 million people in July 2001), a child support grant (a maximum of 110 rands a month; with an uptake of 1.5 million people), and a disability grant (a maximum of 570 rands a month, with an uptake of 634,000 people). Total expenditure on these grants in 2000/01 stood at about 19 billion rands. Estimates suggest that South Africa's social security grants have a significant impact, reducing the average poverty gap by approximately 23 percent.

South Africa also has an unemployment insurance fund that provides a payment of 45 percent of wages for up to six months for workers unemployed from the formal sector, as well as compensation funds and road accident funds. The expenditure of these funds stood at just under 8 billion rands in 2000/01. Most recently, the government has introduced free basic services for the poorest South African households, including free electricity and water. South Africa also has a public health system, with nominal charges, and a public education system that does not require the payment of school fees from the poorest families. The South African government spent more than 32 percent of its consolidated budget (or 80 billion rands) on health and education services alone in 2000/01. Analysis of the fiscal incidence of social expenditure clearly shows that since 1994 there has been a large and significant shift in social spending away from the more affluent to the formerly disadvantaged members of the population. And most social spending is fairly well targeted to reach those most in need of it.

* * *

The overriding objective of South African economic and social policy is to address poverty and inequality—through a series of integrated policies but primarily through economic growth. Like many small emerging countries, South Africa has made a strong commitment to achieving its goals through greater integration with the global economy. In the short term, however, greater integration into the international economy does not remove the structural challenges and constraints that South African economic policymakers have to address in meeting these goals—low savings, high real interest rates, a legacy of inward-looking industrial policies, a low skills and education base, labor market dynamics in part determined by the need to lessen the apartheid-wage gap, and extremely severe, racially defined income inequality.

To some extent, however, greater integration changes the context for addressing these impediments to growth. In some cases it offers important opportunities. For a country with low savings, access to capital markets offers the promise of growth driven by international savings. Greater integration also eases the current account constraint on growth. Greater openness (supported by appropriate policies) can be expected, in the medium to long term, to remove the legacy of inward-looking industrial policies. South Africa's trade performance has been strong, with exports responding particularly well to positive international conditions.

Exposure to the international economy also tends to exacerbate the effects of structural weaknesses, especially those that cannot be addressed in the short term. South Africa's experience with high real interest rates, for instance, and the shedding of unskilled labor exemplify this downside. Both have had negative impacts on growth and poverty. But it would not be correct to attribute these outcomes to "globalization". Ultimately, it is not globalization that determines whether a country achieves its economic goals. It is the evolution of that economy—given its advantages and weaknesses—in the context of greater openness.

Notes

1. Comparisons of relative stability (as measured by the coefficient of variation) reveal that portfolio flows have actually been less volatile than loans or trade credit. The scale of portfolio inflows during this period, however, has averaged more than 10 times that of loans and trade credit (peaking at 10 percent of GDP in 1999).

2. When the value of the contingent liability in fact derives from the divergence between actual and contracted future rates.

3. For example, in the first four months of 1998, investment in the bond market amounted to 2.3 percent of annual GDP; in the following four months, a net outflow of 2.6 percent took place. An even sharper reversal occurred in October 1997, when the crash of the Hong Kong stock market led to an outflow representing 0.7 percent of annual GDP in that month. On the positive side, the London listing of Old Mutual in July 1999 led to net

nonresident investment in equities amounting to a 1.2 percent of GDP in that month alone equivalent to an annualized rate of 14.4 percent of GDP.

4. These were well in excess of those of fast growing emerging economies, such as Chile, Malaysia, and the Republic of Korea.

Turkey

This study provides a detailed overview of the economic reforms in Turkey since 1980 and an account of whether the reforms attained their objectives. As for most developing countries in the late 1970s, Turkey also realized the weaknesses of an import-substitution strategy and moved to a more outward-oriented economic development strategy. Especially in the 1980s, there was an accelerated reform and adjustment process in almost all sectors of the economic system. It started with the liberalization of the foreign trade regime and the financial sector. And it culminated with the liberalization of capital accounts in late 1989, radically changing the policymaking environment.

Trade liberalization

As for many developing economies in the 1960s and 1970s, Turkey's main economic development strategy was centered on import-substitution policies. It was a period characterized by immense public investment programs, aimed at expanding the domestic production capacity in heavy manufacturing and capital goods. Foreign trade was under heavy protection, with quantitative restrictions and a fixed exchange rate regime that, on average, was overvalued, given purchasing power parity.

The strategy involved heavy dependence on imported raw materials, and Turkey's terms of trade deteriorated after the first oil shock in 1973–74. This deterioration put a huge burden on the balance of payments, compensated by short-term borrowing. From 1977 onwards, with shortfalls in imports and problems in the labor market, difficulties emerged on the supply side. With an expansionary fiscal policy maintained on the demand side, imbalances in aggregate supply and demand accelerated the already increasing inflation. Measures to overcome the crisis were inadequate, and second oil shock in 1979 deepened the crisis. Turkey's trade liberalization was initiated to resolve the 1977–79 balance of payments crisis in an environment of low domestic savings and sluggish investment.

On January 24, 1980 decisions were announced to curb inflation, fill the foreign financing gap, and attain a more outward-oriented and market-based economic system. Within the framework of these decisions, export subsidies were granted, and exchange rates were allowed to depreciate in real terms to make Turkish exports more competitive—and promote export-led growth.

The new economic program included export subsidies, a large devaluation, and price increases for goods and services produced by state economic enterprises. The "big push" in the exchange rate, interest rates, and administrated public product prices was coupled with heterodox export incentive schemes, quickly implemented. These moves helped regain the confidence of international creditors. The World Bank adjustment and International Monetary Fund (IMF) Stand-by loans were arranged rapidly, disbursed in conjunction with additional debt relief operations.

Three characteristics of the policy environment facilitated the trade reform. First, net foreign lending allowed the resumption of intermediate good imports and eased pressure on public finance. Because of the low rates of capacity utilization (around 45–50 percent), industrial firms showed a strong export response to the rapidly altered incentive structure. Second, the exchange rate depreciation was high but sustainable. Third, domestic absorption was significantly lowered in the first half of the 1980s to provide room for the initial push in export expansion. In this period, real wages and agricultural incomes were decreased substantially.

Expansion of export incentives and subsidies

In the 1970s export incentive schemes—such as tax rebates, concessional credits, and forex allocations—were already in operation. But without a realistic exchange rate and supportive macroeconomic policies, their impact was limited. The composition of exports shifted in favor of manufacturing, while agriculture maintained its dominance, with an average share of more than 60 percent.

The 1980 adjustment policy package expanded and consolidated the export incentive schemes, improved administrative efficiency, and promoted foreign trade companies. The post-1980 export incentive schemes can be grouped in five categories:

- *Exchange rate kept on a depreciating path.* The government's policy to support exporters was a real depreciation, which amounted to a PPP-plus rule until 1988. After 1988 the Central Bank slowed the rate of depreciation (Rodrik 1991).
- *Direct payments to exporters.* The initial costs of exporters were covered by the government's budget and extra-budgetary funds, with direct payments through tax rebates and cash premia. During 1980–84 tax rebates dominated direct payments, with subsidies reaching 17 percent of the value of manufactured exports in 1984. But pressure on the government budget caused a shift in emphasis from export subsidies to a more active exchange rate policy. Also after 1984, cash premia from extra-budgetary funds became significant due to the approval of GATT code and the phasing out of tax rebates. Import liberalization would also stimulate exports. So direct subsidies for exports were gradually cut, falling to 4.4 percent in 1990 and abolished thereafter.
- *Preferential and subsidized export credits.* The Export Promotion Fund, the Central Bank, the Turkish Development Bank, and the Turkey Eximbank provided subsidized export credits. Rediscount rates for exporters were kept below the commercial interest rates. At the beginning of the 1980s, Central Bank resources were used effectively to promote exports, but after 1984 its credits fell to very low levels. In line with this development, the share of the commercial bank loans in export credits increased, and commercial banks became the dominant lender in the export credit market.
- *Tax exemptions for imported inputs.* Imported goods, used as input in the production of export goods, were exempt from import taxes. So, tax exemptions increased gradually, with the export sector growing.
- *Corporate tax allowances.* Although there is no precise figure for corporate tax allowances, it is estimated that tax allowances increased as export volume increased.

As a result, export subsidies increased as a percentage of the value of total manufactured exports between 1980 and 1984 and then decreased gradually as the export sector became more self-sufficient[1]. The tax rebates were highest for skill-intensive investment goods, and below average for labor- and resource-intensive consumer goods in manufacturing. But, the share of consumer goods was the highest in direct payments, because that product group (including textile and food processing) made up the largest part of manufactured exports.

Import liberalization and structure of protection

By the end of the 1970s import commodities were classified in three lists: Quota List (imports subject to quantitative limits), Liberalized List 1 (including all goods that could be freely imported), and Liberalized List 2 (including all items whose importation required a license). Imports of goods that did not appear in any of the three lists were prohibited. According to the pre-1980 import regime, importers were required to place an advance deposit guarantee with the Central Bank for import activities. In 1979 the deposit requirement rates were set at

20 percent on the value of imports for industrial uses and 40 percent for commercial purposes. Moreover, tariffs and nontariff charges —municipal tax, stamp duty, wharf charge, and production tax—were also imposed on imports (Tiktik 1997).

In the 1970s the composition of imports changed because of the import-substitution strategy. With the domestic production of investment goods, their share in the import bill came down from 47 percent in 1970 to 20 percent in 1980. But the two oil shocks in the 1970s contributed to the increase in the share of intermediate goods in total imports, from 48 percent to 78 percent.

In 1980 the stamp duty on imports was reduced from 25 percent to 1 percent, and import regulations were simplified. In 1981 the Quota List was abolished, and many items were transferred from Liberalized List 2 to the less restrictive Liberalized List 1.

The January 1984 reform of the import regime was a major break with the past. Two principal lists were abolished, and three new lists introduced: Prohibited List, List of Imports Subject to License, and Fund List (covering luxury goods.) Under the new regime, all commodities not explicitly prohibited could be imported. The reductions in quantitative restrictions were accompanied by cuts in the rates of customs duties. The goods on the Fund List were subject to a dollar-denominated surcharge, in addition to the trade taxes. The levy proceeds were channeled to extra-budgetary funds, to serve two purposes: financing social projects, such as mass housing, and providing temporary protection to domestic industries.

In 1985 the Prohibited List was phased out, with banned commodities reduced from 500 items to 3—weapons, ammunition, and narcotics. In 1988, 33 different items were subject to import licenses. In July 1989 the government introduced an "anti-dumping law" to protect domestic production from unfair competition. In 1989 import liberalization gained further momentum. The number of goods subject to licenses was reduced from 33 to 16, with tariffs and levies on imports reduced substantially.

The import regime changed again in 1990. Import guarantee deposits and licensing were phased out entirely. The List of Investment Goods was created. And custom duties and Mass Housing Fund (MHF) levies were consolidated in a single list. After the minor tariff adjustments in 1991 and 1992, a new set of measures was introduced in January 1993. All tariffs and tariff-equivalent charges other than customs duty and MHF charges were eliminated in line with commitments to the European Union (EU), and the remaining reductions in tariffs and MHF were completed by the beginning of 1996[2].

So Turkey managed in the 1980s both to remove quantity rationing and to reduce import tariff levels. The World Bank classified it as an intensive adjuster in 1991.

Customs union with the EU

Turkey established a Customs Union with the EU in January 1, 1996. It agreed to eliminate all the duties and MHF charges imposed on EU and European Free Trade Agreement (EFTA) products, eliminate all the quantitative restrictions, and impose common customs duties for the third countries. The weighted protection rate on EU and EFTA products fell from 5.9 percent to zero. And the import protection rate imposed on third countries' products came down from 10.8 percent to 6 percent. But import duties on some goods (cars, trucks, leather, shoes, ceramics) were deceased gradually. Turkey lowered import duties on these goods by 10 percent in 1997, by 10 percent in 1998 by 15 percent in 1999 and 2000 and by 50 percent in 2001. On January 1, 2001, import duties on goods from third countries fell to the common customs duty level imposed by the EU.

Financial trade liberalization

Since the 1980s individual domestic markets have taken steps to strengthen connections with each other and integrate with the international financial system. All major industrialized countries liberalized their domestic financial markets. Most developing countries followed, Turkey among them. It launched a series of economic, legal and institutional reforms at the beginning of 1980s.

Transformation of the exchange rate regime

The first step to more market-oriented policies was the change of the exchange rate regime. Before the 1980s the exchange rate was fixed with the value of the Turkish lira determined and adjusted according to the changing economic conditions. But lags in adjustment occasionally resulted in significant overvaluations. So a more realistic and flexible exchange rate policy was initiated with the stabilization program in January 1980. The Turkish lira was largely devalued against other currencies, and a uniform rate was established (also eliminating the black market). From May 1981 onward, the Central Bank adjusted exchange rates daily.

At the end of 1982, commercial banks were permitted to hold foreign exchange positions—mainly to facilitate foreign exchange transfers from abroad and from parallel markets (and to prevent capital flight). The rate regime was broadly liberalized on July 7, 1984 with Decree 30:

- Restrictions on importing Turkish lira banknotes, coins, and other means of payments were removed, though exporting Turkish lira items was subject to the government's permission.
- Residents were permitted to hold foreign currency and foreign exchange deposits, and to make payments via foreign exchange.
- The Central Bank was authorized to import and export gold bullion. Banks were also authorized to sell gold bullion in the domestic market.
- Banks were allowed to accept foreign currency deposits from residents, to keep foreign currency abroad, and to engage in foreign exchange transactions.
- Importing and exporting all kinds of securities were allowed. The sale of securities to nonresidents, denominated in foreign currency and issued in Turkey, was allowed.
- Nonresidents were allowed to purchase real estate and real rights in Turkey, by converting foreign exchange and transferring all proceeds through a bank.
- Nonresidents were allowed to invest, engage in commercial activities, purchase shares, engage in partnerships, and open branch offices, representative offices, and agencies by bringing the required capital in foreign exchange.
- Banks gained freedom to fix their own exchange rates within a narrow band around the exchange rate declared by the Central Bank.
- So banks were allowed to freely fix their exchange rates for commercial, noncommercial, and interbank transactions by June 29, 1985.

Deregulation of interest rates

Throughout the 1970s the government controlled deposit and lending interest rates. But real interest rates became negative due to rapid increase in inflation toward the end of the decade. In January 1980 ceilings on deposit and lending interest rates were abolished, since financial funds were rapidly withdrawn from the banking system and channeled into parallel financial markets and foreign exchange. The interest rate deregulation aimed to attract savings into the financial system and encourage competition among financial institutions in order to deepen the financial sector. But major commercial banks set interest rates collectively through "gentlemen's agreements" to prevent further increases in interest rates.

Self-imposed ceilings on deposit interest rates gradually increased due to the excessive demand for credits as well as competitive pressures from the brokerage houses and small banks. Many brokerage houses and small banks that could not make their committed payments failed in the middle of 1982.

Their failure led the government to make new regulations by taking into account the future trend of interest rates. It authorized the nine largest banks to set interest rates and allowed the smaller banks to pay a premium. But large banks were also willing to raise deposit interest rates. In December 1983 the Central Bank was reauthorized to determine deposit interest rates and review them regularly. In June 1987 banks were given freedom to determine their deposit interest rates to some extent with a communiqué from the Central Bank. In October 1988 all kinds of deposit interest rates were freed.

Capital markets law and the establishment of the capital markets board

The Capital Markets Law, enacted in 1981, was an important step in promoting the securities markets. It mainly aimed to regulate, promote, and supervise the capital markets and to protect the rights and benefits of investors through the secure, transparent, and stable functioning of the capital markets.

In 1982 the Capital Markets Board, subject to the provisions of the Capital Markets Law, was founded as a regulatory and supervisory authority for the conditions and functioning of capital markets. Since then the banks and other financial institutions have been subject to the law's provisions and to the board's supervision for their capital market intermediary activities.

Government securities auctions in 1985

Before the 1980s, fiscal deficits were frequently financed by direct monetization through the Central Bank Until 1985 governments preferred not to issue securities to finance fiscal deficits, and the Treasury tended to use the short-term advance facility granted by the Central Bank. Monetary policy was thus mostly dependent on fiscal policy. In May 1985 the government began to issue treasury bills and bonds to finance the budget deficit. The negative impact of fiscal deficits on the Central Bank balance sheet was reduced to some extent by treasury auctions.

The government securities auctions provided the pre-conditions for open market operations at the Central Bank and for a secondary bills and bonds market at the Istanbul Stock Exchange. The government securities auctions provided an attractive alternative investment area for financial and nonfinancial institutions since interest rates of these instruments were determined under market conditions and had zero-credit risk. Moreover, yields of these auctions has been accepted as major rates for the economy since they were determined by competitive bidding and the volume of auctions was high.

After the financial crisis in 1994, the short-term advance facility of the Central Bank to the Treasury was limited by 12 percent of the excess of the current year's total general budget appropriations over the previous fiscal year's total general budget appropriations. This ratio was gradually lowered to 10 percent in 1996, 6 percent in 1997, and 3 percent for subsequent years. With the new Central Bank Law of 2001 the short-term advance facility was forbidden.

Market opening reforms at the central bank

At the beginning of 1986 the Istanbul Stock Exchange began to operate as a secondary market platform for government securities. In the same year, the implementation of monetary policy was modified. Under the new monetary policy regime, the Central Bank mainly aimed to control money supply by controlling total reserves of the banking system. With the rediscount facility limited to medium-term credits, the reserve needs of the deposit money banks could be met only to the extent supplied by the Central Bank. The limitations imposed by the Central Bank on automatic acquisition of reserves by individual banks through the rediscount facility required a market-oriented distribution system to mobilize the excess liquidity in the banking system.

The interbank money market. On April 2, 1986, banks were required to keep collateral at the Central Bank to be able to do transactions in Interbank Money Market. The Interbank Money Market has provided efficient functioning of the banking sector and developed an understanding of cash management.

Open market operations. In February 1987, the Central Bank commenced open market operations as a main tool for implementing monetary policy. The operations aimed to adjust the liquidity of the banking system and thus control the money supply.

Foreign exchange and banknotes markets. In August 1988, foreign exchange and banknotes markets were established at the Central Bank, with daily fixing sessions. The markets are accepted as another monetary policy instrument for using foreign exchange reserves more effectively. The Central Bank announced on January 2, 2002, that it would end its intermediary functions in Interbank Money Market and Foreign Exchange and Banknotes Markets by December 2, 2002.

Capital account liberalization

Capital account liberalization was initiated with the economic and financial reforms that started in 1980 and were fully completed in 1989. Before 1980 capital flows were controlled through foreign exchange controls. After 1980 capital account liberalization was started with the Decrees No. 28 and 30, put in force in December 1983 and July 1984. These decrees partly liberalized the capital accounts, and full capital account liberalization was accomplished in 1989. Decree No. 32 was issued in the Official Gazette on August 11, 1989. With this decree and amendments to it, capital movements were fully liberalized, and the major steps for convertibility were taken. The main points of Decree No. 32:

- Residents can buy foreign exchange without any limitation from the banks or special finance institutions, and they are not subject to any restrictions for keeping foreign exchange.
- Foreign exchange can be brought into the country for all services rendered by residents for nonresidents.
- Nonresidents can buy and sell all the securities listed on the Stock Exchange and the securities issued by permission of the Capital Markets Board.
- Nonresidents can buy and sell, through banks and special finance institutions, the securities quoted on the foreign stock exchange and treasury and government bonds denominated in the currencies bought and sold by the Central Bank—and transfer their purchase value abroad.
- Residents are free to issue, introduce, and sell securities abroad—to bring securities to Turkey and take them out.
- The proceeds of sales and liquidation of foreign capital may be transferred freely out of the country by the banks and special finance institutions.
- Obtaining foreign credits is liberalized.
- Nonresidents are allowed to open Turkish lira accounts and to transfer principal and interests accruing to these accounts in Turkish lira or foreign exchange.
- Blockages on real estate were removed, and the transfer of income and sales value was liberalized.
- Nonresidents are allowed to buy and transfer foreign exchange and send Turkish lira abroad without limit.
- The banks and private financial institutions are obliged to give information about the transfers exceeding $500,000 or its equivalent of foreign exchange, except import, export, and invisible transfers.
- Turkish residents are free to establish liaison offices and representations abroad.

Reforms and regulations concerning the banking sector

The banking has traditionally played a prominent role in the financial system. As a reflection of the liberalization policy of 1980s, a series of institutional and legal reforms took place for the banking sector. The main purpose was to strengthen the soundness and effectiveness of the financial system—by encouraging competition among banks.

Although competition and insurance are accepted as opposite concepts, the Savings Deposit Insurance Fund was necessarily instituted at the Central Bank by means of an amendment to the Banks Act in 1983. The main aim behind the fund was to re-establish public confidence, which deteriorated because of the repeated failures in the banking system, and to protect depositors against the negative effects of the banking crisis. Initially, a nominal upper limit was approved in order to implement for each savings account. Banks were required to participate in the fund.

Since the 1980s two Bank Acts have been ratified and implemented. The first one was the Banks Act enacted on May 2, 1985, consisting mostly of subjects related to the structural problems of the banking system. It aimed to provide a legal basis for prudential regulation and supervision. Within the framework of that act, banks were required to have a standard accounting system, and the Sworn Bank Auditor was authorized to monitor legal performance and financial structure of the banks. Banks were also required to be audited by independent external auditors every year in accord with the globally accepted principals of accounting. The government was authorized to change the management of risky banks, and giving credit to a single customer was restricted.

The Council of Ministers was authorized to specify the main rules in provisioning for nonperforming loans with an amendment of the previous Banks Act in 1983. Then, a decree issued on December 11, 1985, required banks to keep specific loan loss provisions for their unpaid loans as well as general provisions for their whole portfolios.

In January 1987 banks were required to present to the Central Bank their financial reports, which were also audited by the independent external auditors.

In October 1989 banks were required to adopt capital adequacy ratios in line with the Bank for International Settlements guidelines to ensure that they keep enough capital for the risk of their assets. The application of the capital adequacy ratio has facilitated comparisons with banks abroad.

After the stabilization program of April 5, 1994, the already established Savings Deposits Insurance Fund (SDIF) was reorganized to prevent turbulence in the banking sector. The government announced a full guarantee to all savings deposits. The Central Bank law was amended, and the short-term advance facility to the Treasury was limited to increase public confidence.

The second Banks Act, enacted on June 18, 1999, broadened measures to strengthen the financial structures of banks and the supervision mechanism. Accordingly, weak banks that could not be rehabilitated were required to be transferred to the SDIF. The act also aimed to ensure accordance with international standards and the EU implementations in supervision mechanisms. The Banking Regulation and Supervision Agency (BRSA) was established as an organizationally and financially autonomous body to enhance the efficiency, competitiveness, and soundness of the banking sector; to maintain public confidence; and to minimize the potential risks to the economy coming from the banking sector. The Banks Act of 1999 made the conditions for establishing and operating banks more demanding. Banks were also required to establish internal control and risk management systems.

Problems stemming from the fragility of the banking sector continue. One of the main reasons is the weakness of the financial structure of the public banks. Although only 7 of 80 banks were owned by the state, their share in banking assets was 34 percent in 2000. And their financial structures have deteriorated since they finance public expenditures. Due to the accumulated “duty-losses” of these banks, their short-term liquidity requirement has risen. The sharp increases in interest rates during financial crisis have also contributed to this. Since the state-owned banks have usually offered higher interest rates to minimize the costs of huge losses, the competition in the banking sector has been distorted.

Recent macroeconomic developments and reforms

Turkish authorities launched a comprehensive disinflation program in 1998, known as the Staff Monitored Program, with the aim of reducing inflation and improving the fiscal performance of the country. But political uncertainties and the earthquakes in August and November 1999 impeded the program, as did the Asian and the Russian crises.

The government announced a new comprehensive program with the guidance of the IMF at the end of 1999. The program aimed to decrease inflation to single digits by the end of 2002, to reduce the real interest rates, and thus to provide a stable macroeconomic environment that would improve the long-term growth potential. It was basically an exchange rate based stabilization program, which announced the value of the exchange rate basket for the first one and a half years. Afterwards the exchange rate was to fluctuate within a gradually widening band. The program also set limits on some fiscal and monetary aggregates, and introduced important structural measures in agriculture, social security, fiscal management, and privatization to help to achieve the fiscal targets. This went hand-in-hand with an appropriate incomes policy.

With the program, interest rates came down sharply, a result of the removal of exchange rate uncertainty and the decline in the risk premium. Good progress was then attained in curbing inflation, which brought down interest expenditure gave relief in the budget[3]. But, the inertia in inflation led to a real appreciation of the foreign exchange rate. That real appreciation—together with the recovery of domestic demand, the increase in international oil prices, and the weakening of the euro—hurt the current account with a deficit greatly exceeding the levels projected at the beginning of the program.

The worsening of the current account deficit—coupled with the delays in privatization efforts and structural reforms during the second half of the year—blunted capital flows and led to higher short-term interest rates in August 2000. Although the regulatory framework existed in principle with the newly formed BRSA, the key supervision and restructuring measures were delayed due to delays in appointments to the BRSA board and other staffing problems. Besides, the reluctance of the government to take additional measures in the face of a worsening current account deficit led the IMF to postpone the release of the third tranche of the loan in October.

The expectations of international investors quickly turned negative. The rise in interest rates hurt the financial structures of banks that had a high share of government securities in their portfolios and that financed those securities with rather short maturity resources. The deterioration in banks' balance sheets shattered confidence in the financial markets about the sustainability of the program in November. And foreign investors began to reduce their portfolios[4]. The rapid exit of capital created serious liquidity problems for banks, highly dependent on foreign funds.

The outflow, estimated at more than $5.2 billion, sapped the Central Bank's foreign exchange reserves. So interest rates were hiked, hurting the banks that had large government paper portfolios and funded them from the overnight markets. With the hike in short-term interest rates, the prices of both public securities and stock prices went down. The Central Bank provided liquidity to the markets by breaching net domestic asset corridors limits on November 22. An enhanced policy package put into effect in December 2000 and the IMF's support in a Supplementary Reserve Facility helped restore the confidence in the program. So the fluctuations in the markets were partially removed. Interest rates declined significantly, but were still higher than before the crisis. Imports slowed down, and inflation continued to decline, if still higher than the rate of depreciation.

Although capital inflows revived, the November crisis increased the vulnerability of the banking system. The maturity of both domestic and foreign funds shortened after the November crisis and interest rates, still high, fueled suspicions about the sustainability of the foreign exchange regime. Since there still appeared to be serious problems in the fundamentals of the economy, the stability did not last long.

A political dispute in the coalition government eroded market confidence totally, causing an immense attack on foreign exchange on February 19, amounting to $7.6 billion. The Central Bank tried to defend the foreign exchange rate with a squeeze in liquidity, followed by another hike in short-term interest rates. That hike did not hinder the capital outflows[5]. But the liquidity needs of public banks locked up the whole payments system. The unsustainability of the foreign exchange regime became rapidly apparent, and the crawling peg regime, the basic pillar of the 1999 disinflation program, was abandoned on February 22. The dollar rate moved from 680,000 Turkish liras to 960,000 the next day.

In the aftermath of the financial crisis, a new agreement was made with the IMF in May 2001. And a new program, "Turkey's Program for Transition to a Strong Economy" was announced, more decisive about the structural reforms, the program's overall strategy can be summarized in three steps: reduce uncertainty in the financial markets, stabilize the money and the foreign exchange markets, and establish macroeconomic balances.

One aim of the program was to ensure the long-term sustainability of fiscal adjustment and to improve the efficiency of the public sector governance. In this regard, the regulations to strengthen budget discipline and to enhance the revenue resources have been put in place. To combat tax evasion and distribute the tax burden evenly, the tax regulations extend the use of tax identification numbers. Precautions were taken to expand the coverage of the budget and improve fiscal control. And the budgetary, extra-budgetary and revolving funds were closed. A new Law on Public Finance and the Debt Management was submitted to parliament.

Income policy in line with targeted inflation rates was one of the basics of the program. The dialogue with business circles and employee representatives was enhanced to attain moderate wage and price increases. The Economic and Social Council Law, which brings together employers and employees of the public and private sectors and other civil society organizations, had already been enacted in 2000. It aims to develop consensus and collaboration among social groups in formulating economic and social policies.

Although some important measures were taken for the banking sector, such as the BRSA, its fragility deepened during the November 2000 and February 2001 crises. That is why the new program gave top priority to banking reform. The overnight positions of the state and SDIF banks were reduced to ease their pressure on the interest rates. The governance structure of the state-owned banks was reformed to minimize the political influence on the banking sector. The "duty losses" of state banks were eliminated. A plan to resolve the banks taken over by SDIF was implemented, and amendments to Banking Law were approved by the Parliament.

Some important regulatory and institutional reforms

The early reforms of 1980s were important steps to develop a market economy in Turkey. But they have not prevented macroeconomic instability and chronic inflation. As time passed, it became more evident that the reform efforts should be much more comprehensive. The recent crises revealed that the current situation would only worsen without more stringent reforms, especially in the public sector and the banking sector. The EU accession process, which helps to shape reform agenda and provides a benchmark, also plays an important role for Turkey's reform efforts.

Financial sector reforms

Banking Regulation and Supervision Agency. Although important steps were taken in the liberalization of the financial system in the aftermath of 1980s, some severe problems still existed in the banking sector. To contribute to the efficiency, competitiveness and soundness of the banking sector, the BRSA was established with the Banks Act of 1999. The main goals were: to safeguard the rights and benefits of depositors and create the proper environment, thus contributing directly to the achievement of long-run economic growth of the country; to enhance banking sector efficiency and competitiveness; to maintain confidence in the banking sector; to minimize the potential risks to the economy from the banking sector; and to enhance the soundness of the banking sector.

Transition to an independent central bank. The changes under the new law enacted in April 2001 emphasized that the primary objective of the Central Bank was to achieve and maintain price stability. It was prohibited from granting advancing and extending credit to the Treasury and public institutions. It was also prohibited from purchasing debt instruments issued by the Treasury and public institutions in the primary market. The duty periods of vice governors were extended from three years to five. According to the Central Bank Law of 1970, governors could not be excused from office before the end of their duty periods. With the new law, this statement was extended to vice governors, in accord with 14 in European Central Banks System Status. Transparency and accountability were also enhanced.

Public sector reforms

The main aim of the public sector reforms was to ensure transparency and accountability in resource allocation in the public sector.

Transparency. In Turkey, the 1980s and 1990s witnessed the violation of the principle of the budget unity through extra-budgetary funds and duty losses. The flexibility of the budget was lost, and the preparation and the application of the budget became inefficient. With the break in resources and expenditures, the budget system has become inadequate in providing information to decisionmakers. In the 1990s urgent precautions were required to increase the transparency in public accounts and to increase the efficiency of the budget process. So fiscal adjustment measures began to be implemented in 2000. With the new program, important progress has been made in eliminating obstacles and delays in the management of public expenditures—and providing budgetary discipline.

Strengthening public finance and administration. Turkish authorities were aware of the urgency of the effective regulatory management system and took important steps in order to reform the public administration. The attempts have aimed to build an effective, accountable, and merit-based public administration. The first requirement for this was to build a system with the recruitment of civil servants based on the merit of the worker. This required changes to recruitment. The old system was dependent on exams, held by the recruiting agency and based on flexible criteria. Open to abuse, this sometimes lead to favoritism. To prevent this a new examination system was adopted. And a scheme was introduced to fight corruption in the public sector.

Structural measures included rationalizing public expenditures and revenues. Reforms include strengthening public finances and improving operational performance.

Reforms in agriculture. The share of population in agriculture is still extensive, and income inequality is high. So supporting the sector is inevitable.

Earlier support schemes distorted market signals, benefiting rich farmers more than poor ones. Reform programs instituted in 2000 aimed at phasing out support policies and replacing them with a direct income support system targeting poor farmers directly. In accord with the new program, Direct Income Support to the Farmers was introduced.

Social security. Turkey's pension scheme has had serious problems, and it has become a major source of fiscal burden. A reform proposal was enacted in September 1999.

The reform introduced a minimum retirement age of 58 (female) and 60 (male) for contributors entering the system; current contributors are allowed a gradual transition period. The reform changed the benefit formula for new entrants, and provided for gradual expansion of the reference wage period of the full contribution career, to improve the link between contributions and benefits. With the reform, discretionary pension indexation, generally based on civil service wage increases, was replaced with pensions being indexed to the consumer price index, and the ceiling on contributions was raised. Another important development: unemployment insurance. Traditionally, the severance payments program has been the primary form of protection against involuntary employment in Turkey. With the new scheme, put into effect in June 2000, no payments were to be made before February 2002.

The second phase of the reform consisted of institutional improvements. To unify norms and standards, to establish and share a common and reliable database for the three different institutions, and to monitor actuarial and financial developments, a Social Security Institution was established under the Ministry of Labor and Social Security. Health insurance and pension insurance departments within Social

Insurance Corporation and social security were separated. The Turkish Employment Institution was established to monitor the needs and provide the requirements of the active labor markets and to be responsible for the management of the newly founded unemployment insurance system. Another important area of the reform process was the establishment of voluntary-funded private pension schemes, with a view to support public insurance.

Conclusion

Much has been done over the last two decades in integrating Turkey into the world economy. But as some of the main macroeconomic indicators exhibit, the Turkish economy could not adequately benefit from this integration. The main underlying factor for this failure is the short-term orientation of economic policies—by frequently changing coalition governments and postponing structural reforms, mainly in banking, public finance, and public management. High public sector deficits created chronic and high-inflationary environment, impeding the medium-term planning of economic agents. Another factor is the international economy. After the worldwide spread of capital account liberalization measures in the 1990s, the vulnerability of the developing economies to external shocks increased considerably. In that sense, Turkey was no exception. It also suffered from the adverse effects of the economic crisis elsewhere, such as the Gulf War in 1990–91 and the Russian Crisis in 1998. These shocks led to sudden and huge reversals in short-term capital flows throughout the 1990s.

To sum up the overall effect of this integration, the balance of payments problems of the Turkish economy seem to have improved slightly in the last two decades. But this improvement has been coupled with the declining long-term growth rates and with high and persistent inflation. Especially after the liberalization of the capital account at the end of 1989, the growth rate became more volatile and the uncertainty in the economy has increased. The reform has also resulted in more foreign indebtedness. Although per capita income improved, the income distribution has gotten worse.

In an overall assessment of recent decades, one benchmark should be the growth rate. Turkey reached high growth rates of 6 percent a year in the 1960s and 1970s, yet these rates slowed down significantly and became more volatile in the 1980s and 1990s. Even so, the growth rates of the 1980s and the first half of the 1990s seem successful (at around 4.5 percent a year) when compared with the poor growth of other middle-income developing countries in the same period.

Turkey's sluggish performance can be attributed to the fall in gross fixed capital formation as a percentage of GNP in the early 1980s. Scarce public resources led to a decline in public investment. While there was an expansion in the private sector investment, the main driving force of private investment was the rapid increase in construction spending for housing. If housing is excluded from private investment, the ratio of private investment to GNP did not move upward—instead staying at 10–12 percent of GNP.

With the export-led growth strategy in this period, substantial subsidies were provided to exporters. But booming exports did not raise private manufacturing industry's gross fixed capital formation. Private manufacturing industry's gross fixed capital formation was less than 4 percent of GNP in the 1980s, and it increased only slightly in the 1990s. Why? Because unsustainably high public sector borrowing led to high inflation and interest rates, crowding out private investment (Celasun 1994). Indeed, the average growth of 3.9 percent for 1980–99 can be decomposed as 1.6 percent for capital productivity, 1.7 percent for labor productivity, and 0.6 percent for total factor productivity. These figures are low for a high-potential developing economy.

A study by the World Bank (2000) points out that the main sources of productivity growth in Turkey between 1975 and 1990 were changes in the sectoral composition, that is the flow of labor from agriculture to other sectors. That analysis can be extended to developments in labor market and job creation capacity of the economy. Turkey faces a labor absorption problem, evident in unemployment rates. During 1981–97 total employment grew only by 1.5 percent a year while the working-age population (the pool of all potential workers) grew by more than 3 percent (World Bank 2000b).

Either the economy is not growing enough to generate employment for rising population, or it is growing but this growth is not labor-intensive enough. No clear-cut answers are available. Basic trade theory suggests that specialization will follow and labor abundant economies will produce more labor-intensive goods, creating more employment after undertaking substantial efforts to liberalize trade and integrate with the world economy. But, employment creation did follow trade liberalization in Turkey. Nor did the trade reforms improve the economy's general productivity.

Notes

1. In addition to export incentives and subsidies, the Free Trade Zones Law was issued in 1985 with the objective of increasing export oriented investment and production. Mersin and Antalya free zones became operational in 1988; the Aegean and Istanbul Atatürk Airport free zones in 1990, the Trabzon free zone in 1992 and commercial activities have been conducted in the Mardin and East Anatolian free zones since October 1995. Turkey has been a member of World Export Processing Zones Association since 1991.

2. Turkey has been a member of the GATT since 1950. It signed the Uruguay Round Treaties in 1994. It has accepted GATT regulations on textiles, services, and agricultural trade—as well as trade related intellectual property rights. As a result, the Turkish Patent Institute was established in 1994. Turkey also has been a member of the WTO since 1995.

3. Even if the realized inflation figures were above the program targets, they were well below the last 14 year's averages.

4. The main reasons behind the rapid exit of capital in November can be summarized as follows: disappointing inflation results for October, unexpectedly high monthly trade deficits, political difficulties encountered in privatization, worsening relations with the EU, the economic situation in Argentina, and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the SDIF (Akyuz and Boratav, 2002).

5. Overnight rates reached 5,000 percent.

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United Kingdom

Globalization has the potential to deliver substantial economic benefits. But it also brings risks, which policymakers need to address. In general, the global response to these risks has been inadequate.

Liberalization and openness are not enough. To benefit from more openness, a new commitment to good policymaking, responsive to globalization's challenges, is required at the country level. Each country must tackle these challenges in a way appropriate to its domestic setting, but some general principles may be more widely applicable.

The UK experience suggests several such principles:

- Macroeconomic policymaking in a global environment needs to pay particular attention to ensuring credibility and consistency. This can be achieved through a focus on medium-term stability, openness and transparency in the conduct of policy, and appropriate institutional structures.
- Capital market openness strengthens the need for a strong and effective regulatory framework.
- To compete effectively in global markets, countries need structural policies to facilitate a dynamic business sector. Labor market flexibility must be accompanied by investment in education and skills, and a competitive domestic business environment must be encouraged through tough and effective competition policy.
- By itself, a more open and competitive environment cannot guarantee equitable access to resources by all members of society. Policies that address income disparities are needed to ensure equality of opportunity for all.
- Global solutions are needed for global problems, but a commitment to take domestic action in support of internationally agreed initiatives is also necessary, if international policy coordination is to succeed.

Policies to get more from globalization

Global markets provide access to more capital, better technology, greater choice of goods, and the benefits of larger markets and economies of scale. Free flows of goods and capital lead to a more efficient allocation of resources and higher growth and incomes, and increased competition and exposure to world best practice lead to more efficient, responsive, and innovative domestic economies.

But policymakers need to address risks associated with globalization. For example:

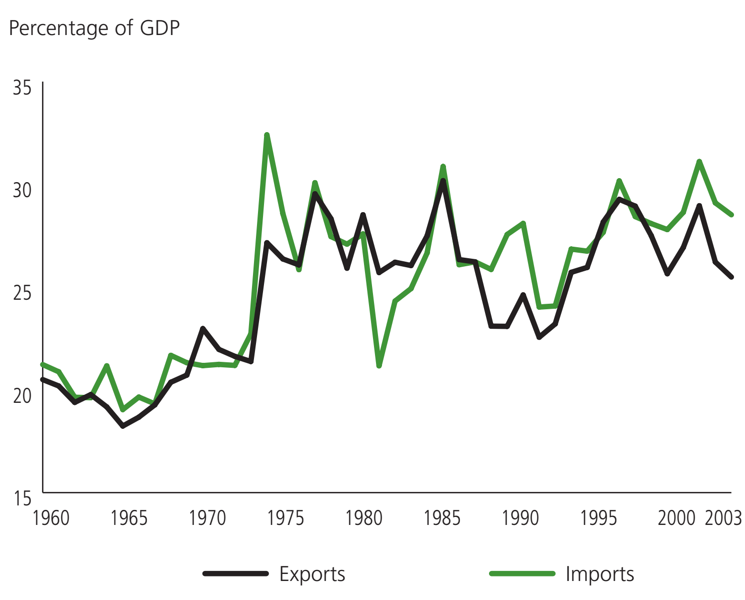
- Macroeconomic and financial stability may be more difficult to achieve with open capital markets and volatile asset prices.
- Integration of financial markets creates opportunities for their abuse (through opportunities to launder money, evade taxes, and finance terrorism).
- New technologies and greater competition can adversely affect particular sectors, regions, or types of workers, leading to divergences in incomes and opportunities.
- With greater economic integration, problems previously dealt with domestically can become international issues, requiring an international response.

Global integration creates change—which labor markets, tax and social security systems, regulatory and institutional arrangements, and fiscal and monetary policy frameworks have often failed to respond to adequately. Above all, globalization is failing to deliver benefits for those who need help most—the millions of poor people whose standards of living fall below the standards set out in the Millennium Development Goals.

Because of these problems, a new global movement for change has developed. But the right response is to enhance global economic cooperation, not to prevent it. Through continuing cooperation, we need to ensure that globalization works for the benefit of all, including the poorest countries:

- We must remove barriers that have prevented countries from sharing in the benefits of integration. The potential benefits of a new trade round to the poorest countries are substantial—and greater than the impact of development assistance.
- We need to invest in citizens, to ensure that everyone can take advantage of the benefits of greater globalization. In particular, there is a need for a step increase in investment in health and education for the poorest countries.
- We need to improve the effectiveness of development assistance: by untying aid, improving donor coordination, and harmonizing procedures; and by budget support coupled with better public management and more targeted assistance towards the poorest countries.
- There needs to be more dialogue between international investors and recipient country governments, to ensure that everyone is able to benefit from the increased opportunities offered by foreign direct investment.

Figure 1. Exports and imports



But there is a need to localize as well as globalize—to seek local solutions within a global framework. Good policymaking at the country level includes:

- Macroeconomic reform, to achieve a stable and predictable fiscal and monetary framework.
- Capital market reform, to create a dynamic financial sector while building an effective and comprehensive regulatory framework.
- Structural reform, to create a more dynamic, efficient, and innovative economy.
- Labor market reform, to promote flexibility and equality of opportunity.
- A commitment to undertake domestic policies necessary to support the international response to global problems.

Trends in the UK

The post-war period saw a steady decline in trade barriers in the UK, driven by successive rounds of GATT negotiations, along with entry into the European Community in 1973. Average effective tariffs for the UK fell from 8.7 percent in 1972 to 4.7 percent in 1979 (Ennew and Reed 1990). Since then, the subsequent effects of the Tokyo Round and Uruguay Round cuts have lowered tariffs for most manufactured goods to negligible levels. But the agricultural and textile sectors remain protected however. With exports and imports together now equal to just over half of national income, the UK ranks as a relatively open economy (figure 1).

Not surprisingly, trade with the European Union (EU) plays a significant role in overall UK trade. The share of intra-EU trade of total UK trade has risen from 42 percent in 1975 to 57 percent in 1999. The UK is one of the most advanced economies in implementing the Single Market initiative, aimed at breaking down further barriers to trade and investment within the EU. There is still room for progress in reducing barriers to trade, both within the EU and between the EU and the rest of the world.

Liberalization of capital markets in the UK has been extensive. Exchange controls were abolished in the UK in 1979, and direct controls on capital markets gradually dismantled, including the removal of indirect controls on bank lending, the abolition of reserve requirements, and the deregulation of the securities market and building society interest rates.

The UK is now one of the most open countries in the world in terms of capital flows. Average daily turnover in the London foreign exchange market makes up over 30 percent of total turnover—the highest in the world. FDI flows increased significantly during the 1990s (figure 2). The UK now ranks second in the world in both inward and outward direct investment stocks.

Creating a stable macroeconomy

A more integrated global economy poses new challenges for macroeconomic policy. Credibility has become more important, and more quickly rewarded by international capital markets, whereas any losses of credibility are more quickly and severely punished. As economies become more integrated, the sources of economic shocks are likely to widen—and be transmitted more quickly. Macroframeworks and the credibility of policies are thus likely to be more severely tested.

In the 1980s and early 1990s, the lack of a credible macroeconomic framework in the UK led to substantial volatility in output, inflation, and interest rates. But, from 1997 onwards, changes to the monetary and fiscal policy frameworks have improved macroeconomic performance, with low and stable inflation and balanced fiscal outcomes (figure 3).

Monetary policy

A broad consensus now exists that price stability is an essential precondition for achieving high and stable levels of growth and employment. But for much of the past two decades, the UK's inflation performance was very poor, despite attempts to tackle the problem through a variety of different policy measures (figure 4).

In the early 1980s the UK government undertook to control inflation through monetary targeting, setting targets for the M3 measure of the money supply for several years in

Figure 2. Foreign direct investment

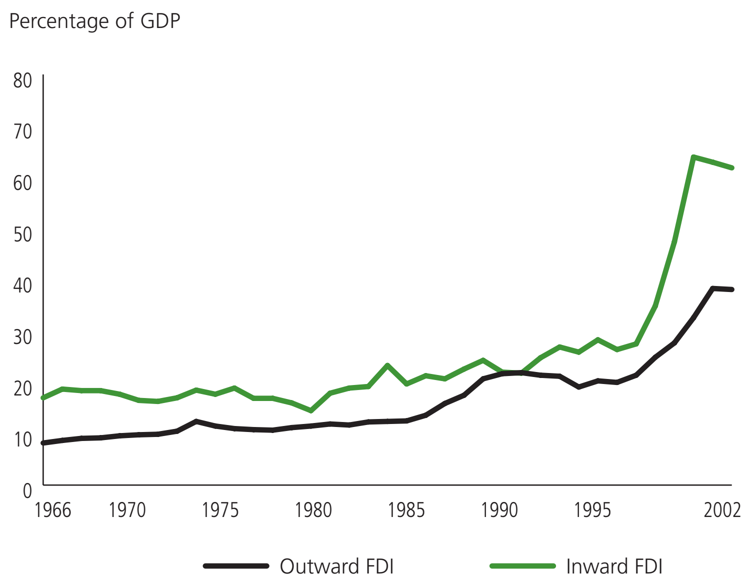
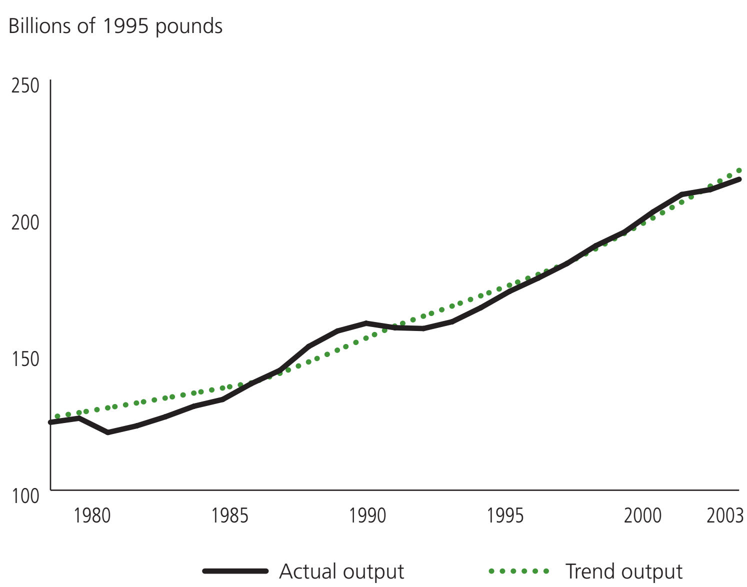


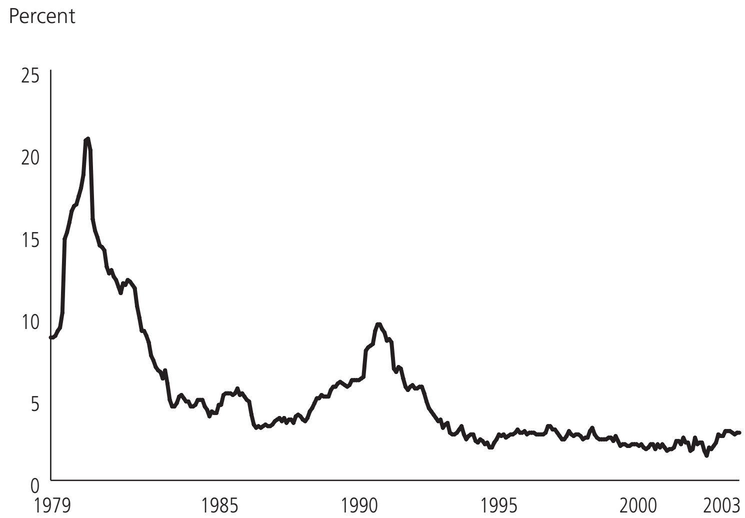
Figure 3. Trend output and actual output



advance, in tandem with projections for the fiscal deficit. But repeated overshooting of the target led to an upward revision, along with the introduction of various other monetary targets. At the same time, the exchange rate began to gain more weight in the assessment of the stance of monetary policy and, later, as an intermediate target.

By 1987 monetary policy had shifted to a policy of pegging the pound informally to the Deutsche mark ("shadowing" it). The stance of monetary policy remained relatively easy

Figure 4. Inflation



until mid-1988, when it became clear that economic activity was considerably more robust than previously thought. This forced a sharp correction in monetary policy: interest rates were raised dramatically in 1989. But by the end of 1990 the UK was in recession and the interest rate was falling again.

The UK entered the Exchange Rate Mechanism in October 1990, but by 1992 tensions started developing. Although the Bundesbank had increased interest rates in 1991 and 1992, a similar move was judged inappropriate for the UK at a time of cyclical weakness. This placed increasing pressure on the exchange rate, with sterling moving to the lower end of its band. Sterling was eventually withdrawn from Exchange Rate Mechanism in the wake of considerable exchange market turbulence.

The UK subsequently adopted a new monetary policy framework, which centered on direct targeting of inflation. Moves were also made to improve the transparency and accountability of policy. But monetary policy remained firmly in the hands of the Chancellor until 1997, when the new Labour government moved to place the operational responsibility for monetary policy in the hands of a new, independent Monetary Policy Committee.

Up to this point, monetary policy had repeatedly failed to maintain price stability:

- The objectives of monetary policy were not specified properly.
- Monetary policy was not sufficiently forward-looking.
- Roles and responsibilities were not clear and consistent.
- Monetary policy decisions were made by politicians, not experts.
- Monetary policy was not transparent or accountable.

These inadequacies of the monetary policy framework meant that even when an apparently firm and irrevocable monetary target was chosen (such as entry into the Exchange Rate Mechanism), the government lacked the credibility to persuade the public of its commitment to the objective. As the government's credibility diminished, the costs of maintaining the exchange rate peg rose, and the probability of exit increased. If targets are to be durable, they must be backed by the appropriate institutional framework to ensure they are also credible.

The new monetary policy framework introduced in 1997 is based on a set of key principles:

- *Clear and sound long term policy objectives.* The inflation target is set by the government to achieve price stability.
- *Pre-commitment, through strong institutional arrangements and procedural rules.* The Monetary Policy Committee is given autonomy to achieve the inflation target.
- *Maximum openness and transparency, and clear accountability.* The Bank of England Act lays down guidelines for the publication of minutes, regular reporting, and clear accountability procedures.

These arrangements provide a clear focus on price stability as the monetary policy goal, along with the flexibility to cope with economic shocks.

Fiscal policy

Monetary policy on its own cannot guarantee stability. Fiscal policy must also be set with the overall goal of macrostability in mind. During the 1980s and early 1990s, fiscal policy often added to volatility and instability. Temporary, cyclical improvements in the fiscal position were misinterpreted as permanent, structural improvements, and the resulting over-optimistic forecasts led to a loosening of fiscal policy in 1988, when the economy was already growing significantly above trend.

As the economy returned to trend, the fiscal position rapidly deteriorated, and the surplus fell faster than forecast in successive budgets. During the ensuing downturn, tax increases and spending restraint were required to return the public finances to a sustainable path. These decisions undermined the effective operation of the automatic stabilizers, amplifying the economic instability. The restraint in public spending also damaged the ability of departments to plan for the medium term, particularly damaging to public investment.

Partly in response to these events, a new fiscal framework has been established, based on five principles of fiscal management—transparency, stability, responsibility, fairness, and efficiency. These are given effect through two firm fiscal rules:

- The golden rule states that, over the economic cycle, the government will borrow to invest and not to fund current spending.
- The sustainable investment rule states that public sector net debt, as a proportion of GDP, will be held over the economic cycle at a stable and prudent level (other things equal, taken to be 40 percent).

Moreover, an explicitly cautious approach is taken to forecasting, including a cautious assumption for trend growth (2.25 percent for the 2001 budget), which is audited by the National Audit Office. The fiscal framework constrains discretion while allowing flexibility in two key respects:

- Both rules are set over the economic cycle, allowing fiscal policy to support monetary policy in smoothing the economic cycle by allowing the automatic stabilizers to operate freely.
- The rules clearly distinguish between current and capital spending, allowing the government to borrow for capital spending, which provides benefits to both current and future generations, making it appropriate that the cost be spread over time in the form of interest and debt repayments.

  To protect public investment and ensure the rules are met, capital and current spending are now planned and managed separately.

Capital market reform

A stable financial environment helps business and consumers invest for the long term. Along with economic stability, it is a necessary precursor to sustainable economic growth. At the same time, the financial system must be sufficiently flexible and innovative to respond to the changing global economic environment and take advantage of the opportunities created by greater economic integration. The benefits of globalization fundamentally depend on the ability of capital to flow freely to the highest returning investment opportunities, regardless of national borders.

Openness to capital flows is necessary to bring the benefits of globalization. But with it comes responsibility for proper risk management to avoid excessive adverse effects from the volatility often associated with these flows. Capital from the rest of the world provides an essential input for many economies. But the rapid withdrawal of mobile capital can contribute to crisis, as in 1997–98. Good financial regulation is essential for the management and mitigation of this risk.

The adoption of codes and standards for regulation of the banking, insurance, and securities sectors will help prevent the building-up of imbalances that can lead to financial crisis. Sound liquidity management by the financial sector is fundamental to avoiding currency and maturity mismatches. Sufficient own capital will help firms survive unexpected losses, reducing the risk of their failure. Prudential regulation should require and support these beneficial practices.

Capital market liberalization in the UK has been accompanied by a series of measures to upgrade prudential and other elements of supervision of financial firms and markets. One of the key themes of reform has been the move towards greater clarity and consistency of objectives. Previously, regulatory responsibility for different areas of financial services was divided between the Bank of England and a number of other regulatory bodies. That responsibility is now held by a single integrated financial services regulator, the Financial Services Authority (FSA).

This was deemed necessary, not only to ensure consistency, but because the distinctions between the banking, securities, and insurance sectors have become increasingly blurred. A single regulator, with a single set of objectives, also provides greater accountability, and constitutes a more efficient use of scarce regulatory resources.

The FSA has statutory objectives to maintain confidence in the financial markets; provide appropriate consumer protection, increase public awareness of financial issues, and fight financial crime. It must ensure that the costs of regulation are outweighed by the benefits. In fulfilling its objectives, the FSA must have regard for the need of the UK to have a competitive, dynamic, and innovative financial sector.

The Bank of England retains responsibility for the overall stability of the financial system. That involves work to strengthen market infrastructure, monitor developments in financial markets worldwide, and in exceptional circumstances undertake liquidity or capital support operations to prevent or limit the impact of financial crisis on the financial system.

The changes that have been introduced have contributed to one of the most competitive and open financial markets in the world. The continued strength of the city of London can be attributed in part to the highly competitive and diversified nature of the UK financial market. At the same time, the UK financial market has become more "internationalized" with rapid growth in cross-border transactions and the international diversification of investors' portfolios.

Creating a dynamic business sector

To compete effectively in global markets, the right conditions must be in place to facilitate a dynamic business sector. Structural policies are needed which:

- Improve the education and skills of the labor force.
- Encourage strong competition.
- Promote enterprise and innovation.
- Improve the climate for investment.

Two of these areas are discussed here: improving skills and competition policy.

Skills for enterprise and growth

The competitive pressure generated by growing world trade increases the importance of investing in skills. The importation of unskilled, labor-intensive goods from less developed countries has reduced the wages of unskilled workers in more developed importing countries, generating greater relative rewards for skill. When global production patterns change to reflect comparative advantage, structural change within the domestic economy is inevitable.

In the UK there has been a shift in employment from manufacturing to services over the last 20 years, and this has given rise to some transitional problems. Due to high interest rates, contractionary fiscal policy, and resulting slow growth, manufacturing employment fell by around a quarter in the early 1980s, and the International Labour Organization unemployment rate more than doubled. This led to an explosion of long-term unemployment. While unemployment came down in the boom of the late 1980s, the recession of the early 1990s saw unemployment increase to very high levels again.

Part of long-term unemployment is due to poor skill levels. The UK lags behind many of its competitors in basic and intermediate skills, despite some progress in recent years. This reduces productivity, making it harder for firms to grow and expand into new fields, and for employees to adapt and build on new technologies. Policies aimed at raising skills and improving the performance of the education system are therefore a key component of the government's policies to promote a dynamic business sector.

Tackling poor basic skills is both an economic and social imperative. People with poor literacy and numeracy skills tend to be in low-paid jobs or suffer lengthy periods of unemployment. A National Strategy for Basic Skills has been introduced in the UK to provide basic numeracy and literacy skills training for adults.

The New Deal is another policy initiative introduced to tackle long-term unemployment. The aim is to provide help and support in finding employment. It provides for regular contact with a personal adviser, access to job search support, support for self-employment, and opportunities for training and work experience. It has surpassed its targets in getting people back to work.

Policies have also been implemented to establish a culture of lifelong learning. The Learning and Skills Council has been established to coordinate, promote, and plan post-16 education and training outside higher education, focusing particularly on employers' needs. Three flagship initiatives have also been introduced to ensure that education and training are accessible to all:

- Individual Learning Accounts, which provide all adults over the age of 19 with the opportunity to organize their own learning. To help break down the financial barriers to learning, the account holders are eligible for discounts on certain courses.
- Learndirect, which has been established to offer flexible, Internet-based adult learning through its website and through a network of over 900 Learndirect centers.
- Information and communications technology learning centers, established across the country, giving everybody the opportunity to raise their information technology skills.

Skilled graduates and postgraduates are vital for a productive economy able to take advantage of the opportunities offered by rapidly developing technologies and scientific advances. To ensure the UK has a world class supply of highly skilled graduates and postgraduates, an ambitious target has been set: by the end of the decade, and for the first time, 50 percent of the UK's young people can expect to go into higher education. As participation increases, more young people from currently under-represented groups are expected to enter higher education.

These policies will increase the opportunities for young people and help the UK develop the human capital it needs for higher productivity growth and coping with the forces of change in globalization.

Encouraging competition

Providing the right conditions for a competitive domestic business environment is important to ensure that consumer welfare is maximized (with low prices and wide choice) and that domestic firms can compete in international markets. This makes it very important to have strong competition policy, and a tough, proactive competition authority to prevent competition-damaging mergers and anti-competitive practices.

Over the last few years the UK has strengthened its competition framework in a number of ways:

- By introducing the Competition Act 1998, giving competition authorities much stronger powers to address anti-competitive behavior, and bringing the UK system more closely into line with the main provisions of European Commission competition law.
- By increasing the budget of the Office of Fair Trading, and appointing a new Director General, John Vickers, a leading economist with strong expertise in competition.
- By introducing the Financial Services and Markets Act 2000, which gives the UK's competition authorities new powers to scrutinize the competition effects of financial services regulations.

A radical package of new reforms has now been proposed, designed to bring about a step-increase in competitive pressures in the UK economy. These reforms include:

- Giving the UK's competition authorities greater independence and power, so that they will be able to take decisions in the overwhelming majority of competition cases, free from political interference.
- Giving the competition authorities a strong legal basis for promoting competition across the economy.
- Modernizing the mergers regime, with competition authorities judging cases against a new competition-based test.
- Making a series of improvements to the UK's complex monopoly regime, which allows competition authorities to looks at the workings of whole markets.

- Providing new procedures to encourage private actions, so that those who are harmed by anti-competitive behavior can get real redress.

However, growing international trade and investment presents new problems for competition authorities, as the companies involved are now frequently multinationals, and as markets for many goods and services can no longer be defined in purely national terms. International coordination of competition cases is thus becoming more necessary.

The UK has been working closely with the EU and other countries to improve international competition policy coordination. In particular, much closer links have been cultivated with the U.S. competition authorities—working towards a shared understanding of analysis and procedures. In recent years, links between UK, European, and North American competition authorities have been strengthened, both formally and informally. The development of the EU–U.S. Mergers Working Group in 1999 has improved understanding of respective approaches to setting remedies in competition cases, compliance monitoring, and dealing with oligopolistic market structures.

Action is also being taken to improve the exchange of information between competition authorities. The Office of Fair Trading hosted an international cartel workshop in the UK last year, since when an informal cartel information-sharing network has developed. The UK is also committed to bringing forward new legislation to allow UK authorities to share information with foreign authorities to assist them with investigations into breaches of competition law. These changes will greatly enhance the ability of competition authorities in all nations to effectively combat anti-competitive practices.

Ensuring equitable outcomes in a changing labor market

If the domestic economy is to adapt successfully to the new environment of global competition and take the opportunities for growth in new areas that globalization provides, and if this structural change is to be achieved with the minimum of transitional costs, labor market flexibility is crucial. But some regions and some groups of the workforce may suffer disproportionately—and for a longer period—from the transitional costs from greater openness. Unemployment and wage inequality must therefore be addressed if the gains from globalization are to be enjoyed throughout the economy.

In the UK labor market reforms in the 1980s focused on deregulation and increasing labor market flexibility. Union rights were gradually eroded, wage-fixing arrangements abolished, and employment protection legislation weakened. At the same time, the value of unemployment benefits was allowed to fall relative to wages, and criteria for entitlement tightened.

These measures increased the flexibility of the UK labor market. But the experience demonstrates that such measures are not enough to ensure that everybody benefits from the structural transformation towards higher growth sectors, particularly those at the bottom end of the labor market.

Throughout the Organisation for Economic Co-operation and Development, there has been a deterioration in the prospects for low skilled and poorly educated workers. In the UK this has been reflected by not only a marked increase in wage inequality, but also a rise in unemployment among the unskilled. Between the early 1980s and the mid-1990s, the percentage of working-age households with no one in work roughly doubled. The persistence of worklessness among those at the bottom end of the labor market has widened the income gap. Between 1977 and 1996–97 income inequality in the UK rose by a third.

The UK's experience suggests that unemployment and low pay can have long-term effects that damage people's chances of getting work and moving up the income scale. A number of policy reforms have been introduced to tackle low pay and poverty directly:

- Making work pay, through reform of the tax and benefit system, underpinned by a national minimum wage. The new Working Families Tax Credit now benefits more than 1.25 million families.

- Easing the transition into work by removing barriers to working such as childcare costs. The childcare tax credit provides direct help with childcare costs for the first time.
- Supporting families and reducing child poverty through benefit reform, targeted funding and (from 2003) a new integrated tax credit for children and an employment tax credit (to replace the Working Families Tax Credit).
- Tackling pensioner poverty through tax and benefit reforms to improve the welfare of all pensioners, including not only the poorest pensioners but also those on low and modest incomes.

Domestic policies to support the international response to global problems

Globalization and the increased international policy coordination that goes with it is enabling policymakers to find solutions to global problems that would be beyond individual states or regional blocs. Environmental problems are one example. Greater international cooperation has helped raise environmental standards and find solutions to many environmental problems already, through coordinated action to limit the use of ozone-depleting substances, put controls on the international trade in endangered species, or combat climate change, for example. But appropriate action must be taken on national basis to ensure that the international response succeeds.

Climate change is perhaps the most serious global environmental problem. The UK's Royal Commission on Environmental Pollution has recommended that the UK should reduce emissions of greenhouse gases by 60 percent of 2000 levels by 2050, and that similar reductions will be required by other developed countries if atmospheric concentrations are to be stabilized. Greenhouse gas emissions affect climatic conditions across the world, but the impact is likely to be most severe in developing countries. Without the international structures established under the auspices of the United Nations, there would be no prospect of addressing this problem.

Under the Kyoto protocol, agreed to in 1997 under the United Nations Framework Convention on Climate Change, developed countries agreed to targets that will reduce their overall emissions of a basket of six greenhouse gases by 5.2 percent below 1990 levels over 2008–12. Because the EU and its member states are able under the protocol, to meet their commitments jointly (so that the EU's target can be redistributed between member states in line with their national circumstances), the UK has agreed to reduce its emissions by 12.5 percent, its legally binding target under the Kyoto Protocol.

Since Kyoto, the UK has been pressing ahead and introducing innovative policies that will have a significant impact. One of these is the climate change levy, a tax on industrial energy use. The levy package also includes exemptions for renewable energy, incentives for industry to agree to energy efficiency targets, enhanced capital allowances for investment in energy efficiency measures, and extra resources for the promotion of energy efficiency. The levy package and agreements with energy-intensive sectors are expected to reduce UK emissions by 5 million tons of carbon per year by 2010, compared with "business as usual".

Arrangements are also being put in place in the UK for a voluntary emissions trading scheme, expected to save an additional 0.8 million tons of carbon per year by 2010. International emissions trading would offer scope for countries to work together to reduce their emissions at the lowest possible cost.

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United States

There is little doubt that global trade and investment have made vital contributions to U.S. economic performance. Especially evident in the 1990s, this continues to be so in this new decade as well. It is noteworthy that the interaction of the United States with the global economy achieved new high levels as the “new” U.S. economy flourished during that period.

U.S. involvement with the global economy, as reflected in standard measures of openness to trade, has been increasing steadily in recent years. For example, the ratio of trade in goods and services (exports plus imports) to GDP has been rising for several decades and now stands at more than 25 percent. Other measures—such as import penetration rates, exposure to foreign competition, and trade-weighted tariffs—underscore the openness of the U.S. economy.

But one should be careful not to overstate the extent of U.S. openness. The U.S. trade-to-GDP ratio now is not far above levels reached in the early 1900s and to some extent, the liberalization of U.S. trade in recent decades has been a process of unwinding protection imposed during the middle of the 20th century (as has been the case for many other industrial countries). Alternative measures (such as cross-border price dispersion) also suggest that the United States still has room to move toward even fuller integration with the global economy.

Gains from trade

There is no doubt that, as the United States has become more involved in the global economy, it has benefited enormously from what are often referred to as the standard gains from trade. More open trade has allowed U.S. producers to concentrate activity where they have the best knowledge, skills, and resources. Trade has given them access to a wider range of cheaper inputs. More and better products have been made available at lower cost to U.S. consumers, raising living standards.

Economists often debate whether the result from any particular trade-opening step or change in economic fundamentals that generates additional trade is merely a one-time gain, in which the economy shifts to a new higher level of performance, or whether such a step supports sustained higher growth. The experience of the 1990s—not just in the United States, but in the broader global economy too—strongly suggests that trade and technological change reinforce one another, and that the resulting synergies lead to higher real economic growth over a prolonged period. But such synergies are not a given or automatic, and they depend on certain key conditions.

The trade-technology-growth interrelationship is complex, but more open U.S. trade clearly has heightened competition, spurring innovation and rapid adoption of new technologies. The expansion of global markets has encouraged U.S. firms to take advantage of economies of scale, economies of scope, and network effects. Dynamic interactions of this sort have been especially apparent in industries where fixed investment costs are high, where substantial research and development expenditure is required, and where learning curve effects are important. The computer software, semiconductor, airframe, entertainment, and pharmaceutical industries provide examples. A key feature of the 1990s was a clustering of important technological changes in communications and information technology that helped lower costs directly. These advances also facilitated reorganizations of a wide range of economic activities, generating efficiencies at the firm level, globally, and at levels of aggregation in between. The consequences have been evident in the high sustained rates of productivity growth during the recent long period of U.S. expansion and prosperity.

Further evidence of these forces is seen in changing patterns of U.S. trade. Capital goods trade (which includes sectors with a significant high-tech component, such as computers, machinery, and telecommunications) has exhibited especially rapid growth. Capital goods now make up more than 30 percent of U.S. merchandise imports, twice the share of 20 years ago. Capital goods exports have recorded a similar expansion. In the past 10 years, U.S. exports of computers, semiconductors, and telecommunications equipment increased almost two and a half times. Many of the same forces have been at work behind a similar dramatic expansion of U.S. service exports. The annual growth rate of service exports in knowledge-based areas—such as intellectual property, education, insurance, financial services, and other professional services—has averaged close to 9 percent during the past decade.

Increased foreign competition (and potential competition) has exerted a beneficial disciplining effect on U.S. producers, who have had to keep quality up and prices down to compete effectively in global markets and at home. Faced with foreign competition, U.S. makers in many instances have identified more viable market segments and successfully retooled. (The reaction of U.S. computer chip makers to the challenge posed by lower defect rates on Japanese chips and the response of U.S. auto makers to foreign competition are often-cited examples.) The availability of less-expensive, imported goods has kept U.S. domestic prices down across a wide range of products—from high-tech components, to clothing and footwear, to toys—and, together with a strong dollar, contributed importantly to the low-inflation environment achieved during the past 10 years. It has been argued that greater openness also has helped lower the nonaccelerating inflation rate of unemployment through its positive effects on real wages and productivity.

Foreign investment and multinational corporations

New technology and a more open global trading system have allowed U.S. multinational corporations (MNCs) to establish global supply chains within which stages of production can be placed where labor and materials are cheapest—thereby letting U.S. firms concentrate in core competencies through a variety of multinational firm structures. In some cases intermediate inputs are obtained by outsourcing; in others, key stages of production are relocated, but still retained within an MNC's overall structure. Often fabrication and assembly operations have been moved abroad, while research and development activities, new product design, marketing, and some capital-intensive stages of production have been retained in the United States.

Outsourcing and transfers of operations within U.S.-headquartered MNCs have been a noteworthy feature of economic relations especially with our North American trading partners. Two-way trade between the United States and both Canada and Mexico has helped U.S. automakers, for example, respond to changing economic conditions and still deliver high-quality products at competitive prices. Some observers argue that shifting operations abroad has greatly reduced domestic value added in U.S. MNCs. In fact, the domestic content of production by U.S.-based parent companies has remained high (at about 90 percent).

In cases where MNC production is aimed primarily at foreign sales, local affiliates can also play a key role in providing essential information about local demand conditions and other input for effective marketing. The importance and success of these arrangements can be gauged by the fact that roughly two-thirds of U.S. export sales now are conducted through U.S. MNCs. In many instances, large U.S. companies in industries that one might suppose to be essentially domestic in their focus (restaurant chains, beverage producers, filmmakers) earn the majority of their revenues from overseas sales.

Direct investment flows associated with MNCs have been significant in both directions. In recent years, inward direct foreign investment (and the resulting presence of foreign MNCs in the U.S. economy) has expanded very rapidly, faster than corresponding outward investment. Although inward flows have tended to be associated more often with mergers and acquisitions than with new investment, to some extent certain operations of foreign MNCs and related jobs—quite often, high-wage jobs—have been shifted into the United States in the process. When direct investment inflows became prominent in the late 1980s, concerns were expressed about potential dominance of U.S. markets by foreign-owned MNCs. For the most part, such deleterious effects have not materialized, and foreign MNCs are regarded as having made a welcome contribution to the U.S. economy. U.S. authorities continue to monitor direct investment inflows to ensure that their effects on market structure and competition are consistent with U.S. anti-trust standards, just as they monitor domestic investment flows.

The global activities of MNCs have raised issues about international taxation and the repatriation of profits and capital. In general, historical experience confirms that restrictions on repatriation, capital controls, and similar limitations can have a very potent damping effect on capital flows and distort investment decisions. In certain circumstances they risk prompting sudden, widespread capital flight, with broader negative consequences for both investors and their foreign hosts. Accordingly, U.S. authorities have promoted actively the free international movement of direct investment flows, unencumbered by such restrictions, and have defended the right of U.S. firms to repatriate profits and capital. U.S. authorities in recent years also have worked successfully to reduce double taxation on cross-border capital flows through bilateral tax treaties (and an international model on which such treaties are based) that generally limit the taxing rights of host countries.

Trade-opening policy and supporting infrastructure

Although the increased openness of the U.S. economy is to some extent the result of forces experienced widely and for some time in the global economy, U.S. openness has been fostered by specific policy steps to break down impediments to the free flow of products and factors of production. For many years, the U.S. has been in the forefront of the global effort to lower trade barriers, and our levels of protection are among the lowest in the world. (In part because foreign barriers subject to agreed-upon reductions have tended to be higher that those in the United States, this process on balance has most likely resulted in an improved U.S. terms of trade.)

Prominent among agreements on trade and investment that have been successfully negotiated and implemented in recent years are: completion of the GATT Uruguay Round, the establishment of the North America Free Trade Agreement (NAFTA), and the extension of normal trade relations to China. The United States is now moving toward the final stage of free trade negotiations with Singapore and the Free Trade Area of the Americas and has just concluded a free trade agreement with Chile. The Trade Promotion Authority bill, signed in August 2002, should facilitate additional trade-liberalizing agreements.

As tariff barriers have come down, attention in the public debate on trade policy has shifted to nontariff barriers, for which the scale, extent, and economic impacts are more difficult to measure. The United States has made progress in lowering these as well, but there is room for further progress. The phase-out of existing quotas on textiles and apparel will not be completed until January 2005, tariff-rate quotas remain on a number of agricultural products, and domestic trade remedies continue to be used.

The trade-opening event with the most prominent impact in recent years is NAFTA. Starting in about 1994, the first year of NAFTA, U.S. trade data exhibit a well-defined structural break. Closer economic integration within North America clearly accounts for much of the steeper rates of increase recorded since then for exports and (with somewhat less certainty) for imports as well. Since 1994 U.S. import and export shares with NAFTA partners have risen roughly four percentage points, of which an important part is attributable to cross-border North American trade facilitated by U.S. MNCs, as noted earlier.

To a great extent, U.S. success in generating and applying new technologies in the more global marketplace has depended on certain essential attributes of the U.S. economy and its supporting infrastructure. A key element in adapting to change and achieving the best allocation of resources has been the flexibility of the U.S. labor market. U.S. firms have been less burdened than those in many other countries by restrictions on hiring and separations or by other job rules. The high-quality U.S. work force—augmented to a considerable extent in recent years by new foreign workers—has met the need for specialized skills demanded by an economic environment where technical change is occurring at a rapid pace. Turnover and job mobility have constituted an important channel through which knowledge-based skills and human capital have been spread more widely—including the spillover effects from the so-called "new" economy into the "old" one.

The efficiency and depth of U.S. capital markets—particularly, the widespread availability of venture finance (through venture-capital providers and direct equity financing) for start-up operations—have been key elements supporting innovation, growth, and trade. Such outside financing has proved especially critical for small and medium-sized U.S. firms, where a disproportionate share of new jobs have tended to originate in recent years. Despite the speculative excesses highlighted by the recent correction in U.S. high-tech stock prices, evidence is strong that the wider range of financing options available in U.S. markets (when compared with the heavily bank-based, inside financing pattern prevalent in many other industrial countries) provides a more supportive framework for innovation, diffusion of new technology, and capital deepening.

Other institutional aspects of the U.S. economy that also deserve to be highlighted for contributing to success in meeting the challenges of globalization are: well-established, clear legal standards (including standards for protection of intellectual property) that are backed by reliable enforcement; accepted accounting practices that (even in the light of recent failures at some prominent firms) support a high level of transparency; an effective regulatory-supervisory structure, with clear rules that strike a balance between limiting anti-competitive behaviors and fostering enterprise and innovation; and policies that deliver a stable macroeconomic environment.

Costs and challenges of globalization

Despite its many benefits, the globalization process has not come without strains. If present trends continue, globalization may present important future challenges, some of which have been raised in recent public debate. The U.S. economy has experienced, for example, many of the usual dislocations that are unavoidable side-effects of rapid growth and change—including changing job mix; restructuring, relocation, and closing of firms; job losses in some sectors; and reductions in earnings. But this process and its impacts have been eased by a number of targeted programs, including Trade Adjustment Assistance, NAFTA Transitional Adjustment Assistance, and the Dislocated Worker Program (which provides assistance with job search, placement, and training). Additional programs are aimed at smoothing economic adjustment at the community level.

It has been argued that the gains from trade have not been spread evenly across the U.S. economy. It is well documented that for several decades, at least up to the mid-1990s, there was a steady widening of wage inequality across skill groups in the U.S. workforce. Observed in other industrial countries as well, this was considerably more pronounced in the United States. (At the same time, U.S. within-group wage inequality also increased markedly.) In part because these changes coincided with a period of accelerating globalization, foreign trade was identified as a possible cause.

It appears from research so far, however, that only a small share of the observed shift toward greater U.S. wage inequality can be traced to foreign trade. Other factors such as skill-biased technological change, shifts in labor supply, and structural changes in U.S. labor markets mattered more. Similarly, it has been hard to confirm any important lasting effect on the U.S. wage distribution from the operations of MNCs—either U.S. MNCs operating abroad or foreign MNCs in the U.S. economy. But given the complex linkages among trade, investment, technological change, and other relevant factors, it is difficult to isolate the separate contribution of any one factor to changes in wage inequality. These are still open questions.

The public debate that often accompanies prominent measures to open trade typically has concentrated on associated job losses or gains. In the case of NAFTA, for example, the range of estimates of such impacts is wide, but on balance the evidence suggests that the medium-term effects of NAFTA-related trade on U.S. employment are likely to have been fairly small. In any event, widespread concerns expressed in the early 1990s about potentially massive U.S. job losses arising from NAFTA have not been realized. (Likewise, the sometimes contentious public debate on job-loss associated with activities of MNCs has come to no firm conclusions—with both positive and negative estimates in play.) It is worth noting, however, that like many other recent U.S. trade-opening agreements, the employment effects of NAFTA have been cushioned by arrangements for a fairly extended phase-in, with side-agreements to mitigate the immediate impact on labor.

Whatever may have been the direction and scale of these impacts, several points are clear. The U.S. labor market was better able to absorb these changes during a period of rapid expansion with record low rates of unemployment. To a great extent, the necessary adjustments occurred largely through the operation of market forces and were not heavily managed or resisted with government intervention. Moreover, the common short-run focus on job impacts may be misplaced. The U.S. experience suggests that, after accounting for cyclical effects, a smoothly functioning economy should ensure that the longer-run effects on total employment are negligible. Indeed, it is difficult to find credible evidence that trade or direct investment has affected the level of total employment in this country over the long run.

U.S. financial markets have been essentially open to free flow of international capital for quite some time. But the combination of restructuring and technical change in financial institutions seen in recent years, as well reductions of some foreign barriers to flows, has expanded greatly the scale of financial flows both into and out of U.S. markets lately. This has resulted in greater diversification in patterns of fundraising and investment in both U.S. and foreign portfolios. (For example, about 15 percent of fundraising through issuance of new securities by U.S. corporations now is from foreign sources.)

It would seem unlikely that the diversification process is complete, however, as there appears to be considerable scope for recent trends to continue. The aggregate U.S. private-sector investment portfolio still exhibits a high degree of "home bias", meaning that the share of foreign assets is relatively low and far from their corresponding share in total global capitalization. Among equities, for example, total foreign equities held in the aggregate U.S. portfolio (including direct investment holdings) make up only about 20 percent of total equity holdings—compared with the roughly 50 percent share that foreign equities make up in total global capitalization.

A corollary of the openness of U.S. financial markets is that there is no short-term necessity for domestic saving to equal domestic investment. During the 1990s domestic saving and investment diverged, and the U.S. current account deficit expanded significantly to the point now where the annual deficit is more than $500 billion, approaching 5 percent of GDP. In some other settings, such numbers would set off alarms—and the current imbalance indeed presents some potential risks. But to a great extent the expanding financial inflows that are the counterpart of the widening U.S. current account deficit reflect investors' positive assessment of the strength and stability of the U.S. economy and their resulting desire to continue to invest in U.S. assets.

It is worth adding that the deficits of the 1990s—in contrast to those of the 1980s—occurred in a context of strong U.S. investment growth. Open, smoothly functioning U.S.

capital markets directed these financial inflows into productive uses that supported U.S. capital formation, boosting productivity and potential output growth. A key development that facilitated this process was the increase in aggregate government saving associated with the movement into surplus of the U.S. federal budget. But even though the budget lately has moved back into deficit and even after the recent correction in U.S. stock markets, the favorable fundamentals exhibited by the U.S. economy evidently continue to attract foreign (and domestic) investors to U.S. dollar-denominated assets. Indeed, foreigners' purchases of U.S. corporate securities (equities and bonds) and agency debt alone generally have been more than sufficient to finance the current account deficit.

Policy in the open economy

Recent experiences have demonstrated that sound policies are critical to reaping the full benefits of integration. The broader risks associated with volatility and the importance of such policies were made dramatically apparent in the global financial crises of the late 1990s. In many respects U.S. financial markets, the U.S. banking system, and the real economy avoided the worst potential impacts, but they were not entirely spared. In late 1998, for example, when default of a major U.S. hedge fund (LTCM) with potentially widespread systemic consequences appeared to be imminent, U.S. authorities facilitated an emergency private-sector recapitalization, with an arrangement to reduce LTCM's positions in an orderly fashion. This step, along with the Federal Reserve's monetary easing in mid-October 1998, seemed to calm markets eventually, but not without some residual effects persisting for quite a while.

The global financial crises of that time, and especially the events surrounding the near-default of LTCM, revealed a number of weaknesses of U.S. (and other) financial institutions active in global markets. Among them: inadequate counterparty credit assessment, lack of information on aggregate exposures, inadequate risk management, concentration of activity in a few large institutions, and hazards associated with convergence of trading strategies. Since then, steps have been taken to address some of these problems—many as part of the broad international effort to improve the global financial architecture. This includes initiatives to promote improved approaches to risk management, increased transparency, more effective monitoring of markets with potential vulnerability, and an expansion of resources available for financial supervision—in all of which the United States continues to be an active supporter and participant. Efforts in several of these areas were accelerated—with some substantial resulting progress—in response to the recent round of corporate scandals.

Over the past decade, some of the largest U.S. banks and other financial institutions have increased their overseas activities substantially—often as the result of mergers and acquisitions—creating new challenges for U.S. and foreign financial supervisors. While expanded operations and new financial instruments have enabled institutions to shift risk more easily (and hence to manage risk more effectively), both the financial institutions themselves and the transactions they perform have become more complex, and the speed with which an institution's positions and risks can change has increased. In response, U.S. and other bank supervisors have placed more emphasis on evaluating banks' risk management systems, rather than on their transactions. In addition, supervisors have recognized the need to rely more on market discipline, prompting in turn an increased emphasis on improved disclosure by banks and other financial institutions.

Globalization also has affected importantly the context for conducting U.S. macroeconomic policy. Obviously, a more open, globally integrated economy means that the United States is more exposed to economic and financial shocks arising in the external sector. There has been no shortage of such shocks in recent years. The transmission channels of U.S. policy to the domestic economy also have been altered by globalization. Because external trade acts as an automatic stabilizer, effects on the U.S. economy of domestic shocks, including some policy shocks, tend to be more muted as openness increases. But other external channels may work in the opposite direction. Accordingly, there is a need to calibrate policy carefully to account for the structural changes associated with the process of globalization. U.S. monetary policy must now take account of spillovers to the global economy—including potential systemic effects in global financial markets, that may feed back to the United States in a non-negligible way. But it remains focused on its mandated objectives of price stability and full employment.

Economic Reform in this Era of Globalization

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