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TRADE AND FINANCE: AN SHD CENTRED CONCEPTUAL AND OPERATIONAL FRAMEWORK

I. INTRODUCTION

1. Policies towards international trade and finance are central to how countries manage their integration into the international economy. They have also been identified as critical to development. The purpose of this note is to provide a *tour d'horizon* of the subject, so as to contribute to the elucidation of the international economic policies needed to launch a process of Sustainable Human Development (SHD) in countries participating in the UNCTAD/UNDP Global Programme on Globalization, Liberalization and Sustainable Human Development.

2. There are basically two polar approaches to this set of issues. At one extreme, there are the advocates of delinking in trade and finance. Delinking in trade, according to this view, is necessary because developing countries are at a serious competitive disadvantage and, if they are to gain in relation to their trading partners and build new capabilities, they need to be spared a competition that can only destroy existing industries and capabilities. In finance, the argument tends to be similar: transnational corporations (TNCs), which can be expected to be more efficient than national firms in the same sectors, can pre-empt the development of a strong national enterprise sector. The policy implications are very simple: protectionism in trade and closure of the economy to foreign direct investment (FDI).

3. This approach has undoubted attractions. Virtually none of the few countries to make it out of underdevelopment in the twentieth century did so without passing through a period, sometimes quite prolonged, of protectionism. While experiences with regard to FDI have been more varied, most successful newcomers have also practised selective policies towards foreign investors. However, a large number of developing countries that resorted to protectionism and restrictive FDI policies failed to achieve sustained growth and development, basically because such policies failed to promote learning and knowledge accumulation and, instead, degenerated into rent-seeking (Bruton, 1998).

4. At the other extreme, one finds the advocates of unrestricted trade and FDI liberalization. One of the central tenets of mainstream economics is that free trade maximizes economic efficiency and current welfare. With regard to FDI, it is argued that TNCs can only bring good things with them: capital, technology, access to markets. A view that has been gaining ground in recent years is that FDI is nothing other than a form of trade: TNCs must choose between supplying a foreign market through FDI or through producing in situ. Therefore, the new argument in favour of liberalizing policies towards TNCs tends to be assimilated with the old argument in favour of free trade.

5. The classical arguments in favour of free trade have been recast in terms of growth. It is now argued that free trade is beneficial for growth because it fosters competition (and, hence, productivity growth) and it allows countries to reap the benefits of the economies of scales associated with exporting[1]. Openness to international trade (in producer goods containing new technologies) and to TNCs contributions may also be desirable for other reasons: most technical changes in developing countries are imported, be it in the form of capital and intermediate goods or in the form of FDI. A closed economy implies low ratios of trade to GDP and either no or very little FDI. When trade shrinks, countries are unable to purchase the technology embodied in imports; likewise, when countries are closed to FDI, they forego the proprietary technology that TNCs possess.

6. However, building up national capabilities and improving the way a country is integrated into the international economy are sine qua non aspects of development. This goal may involve a degree of national producer's protection (where markets are large enough), deliberate policies to stimulate technological upgrading, the improvement in the quality of national human resources, policies to encourage production by small and medium-scale enterprises (SMEs), and policies to steer TNCs to effectively deploy the assets for which they are sought after in developing countries. Besides technology and access to new markets, these also include the development of domestic suppliers of inputs and of users of their outputs.

7. There is an ample, although not always conclusive, literature on the relationship between trade liberalization and growth (see Rodrik, 1992a ; Helleiner, 1990 ; UNCTAD, 1989, chapter V; UNCTAD, 1992, Part III, chapter I ; Sachs and Warner, 1995). Much has also been written about the relationship between FDI and development (for a summary of this literature, see Caves, 1996, chapter 9 ; and UNCTAD, 1999). In the light of this literature, the standard hypothesis that both trade liberalization and liberalization of FDI policies are inevitably growth-enhancing needs to be strongly qualified, and we will undertake part of this task below. Recently, the UNCTAD secretariat has persuasively argued that unfettered globalization has led to greater inequality among countries and within countries (UNCTAD, 1997, Part Two). The implication is that more purposeful policies, both at the international and national levels are needed in order to achieve fast growth across a broad spectrum of developing countries.

8. As the current financial crisis show, policies towards non-FDI financial flows should be very prudent in countries where domestic financial markets are undeveloped, banking regulation is incipient, and the real sector is very vulnerable to excessive volatility in the exchange rate and in interest rates. Otherwise, any development strategy, no matter how carefully designed and implemented, can simply be derailed by forces beyond the country's control.

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[1]Some of these arguments may be found in Edwards (1993).

9. There is a role for tapping international financial markets for development purposes, and we explore some of them below. Given the fragilities that are typical of low income countries, however, these should normally involve national official development financial institutions or be heavily regulated. Multilateral financial institutions, particularly those dealing with private sector finance, should have a very important role to play in assisting developing countries in this respect and in providing technical cooperation in this critical area.

10. This paper deals with the elaboration of an SHD-oriented growth strategy from the point of view of its requirements in the areas of international trade, labour and domestic financial markets, international finance, and foreign direct investment. Section II deals with the notion of SHD. In Sections III through VI, we take up issues relating to trade, domestic labour and financial markets, international financial flows, and FDI, respectively. Section VII wraps up the discussion. In Annex I, we present a synoptic view of what the studies for individual countries ought to include in each one of these areas, with some suggestions for specific indicators of policy change and SHD-oriented performance.

11. We assume from the outset that stabilization issues are conceptually separate from those dealt with here. Since no programme of structural change can be successful in the absence of prior stabilization, we are implicitly assuming that an acceptable degree of price stability has been achieved. There are, however, a large number of connections between policies oriented to the structural change objective and those aimed at stabilization; and there can often be contradictions between these two objectives (see Toye, 1999). These clearly must be kept in mind in policy design.

II. WHAT IS MEANT BY SHD?

12. There is widespread agreement that development without economic growth is unviable. No country has been able to attain higher levels of income for a broad spectrum of its population without a high rate of growth in incomes per capita sustained over several decades. There is also agreement that development is a broader process than growth, encompassing considerations of poverty reduction, equity, greater gender equality, greater productive employment for all, higher quality of employment, access to social services (e.g., education and health) that are indispensable for life with dignity, and preservation of the environment for future generations; in sum, the enhancement of the capabilities of people to satisfy their own needs (Sen, 1984). In the United Nations, this broader notion of development has come to be known by the concept of Sustainable Human Development (SHD).

13. Among the variables making up SHD, many correlate positively with per capita GDP and its growth. But experience shows that this correlation is far from perfect. Therefore, if the growth process is to benefit broad segments of the population, it will have to be accompanied by changes in a wide variety of indicators. Some of these are :

(1) Variables related to the rate of economic growth. A spurt of growth, followed by stagnation or declining output, is not conducive to SHD. This has been the characteristic of growth in many countries that have followed exchange-rate-based stabilization policies. Therefore, one of the major characteristics of SHD is *sustained long-term growth*.

(2) Indicators of *poverty alleviation*, *improvements in income distribution, and the distribution of productive assets* (land, physical capital, and human capital). These are complementary to high growth and indispensable in the achievement of SHD.

(3) Indicators of the quality of life. These include indicators of health (availability of medical services, incidence of disease), education (school enrolment ratios, illiteracy), life expectancy at birth, and gender-related indicators of welfare.

(4) Variables related to the structure of the economy. Another important aspect of SHD is structural change, both with regard to the structure of production and exports. In fact, it will be difficult to achieve both high growth, poverty alleviation, and improving income distribution without structural change. On the other hand, structural change is intimately related to the manner in which the domestic economy articulates itself to the international economy. Therefore, structural change has two aspects:

- Most low-income countries have large subsistence or very low-productivity sectors, usually in agriculture and urban informal services. The elimination (or drastic reduction in) structural heterogeneity is a precondition for achieving higher wages, better quality employment, and improvements in the standard of living of the majority of the population.

- Exports are concentrated in one or a few primary commodities, where wages are low and labour skills are rudimentary. Structural change implies diversifying the export basket and moving towards international competitiveness in a wider range of activities.

(5) An aspect intimately related to structural change is *employment in the modern sector of the economy* and shift over time in the structure of employment.

(6) An indicator of improving income distribution and poverty alleviation relates to the *behaviour of average wages and the wage structure*. An increase in average wages relative to GDP, in the context of rapid growth, is prima facie evidence of poverty alleviation and a better income distribution. So is a decline in the dispersion of wage rates (of course, in the presence of rapid growth ; slow growth or declining incomes, together with lower dispersion of wage might mean that more people are poor).

(7) An important objective of SHD is to improve the conditions of women. Therefore, attention will have to be given to *labour force participation rates of women*, the share of women in modern-sector employment, the quality and women employment, and the relative wages of women.

(8) The extent to which the economy is preparing for structural change in the ways defined above and for a better quality insertion into the international economy will depend in no small measure on the *training activities that are undertaken at the enterprise level*. Therefore, labour force training at the enterprise level and its evolution are leading indicators of the gains in SHD that can be expected in the future.

(9) So are *indicators of technological upgrading* : R&D expenditures by firms of various sizes, expenditures on technology licensing by firms, productivity growth in the small and medium-size enterprise (SME) sector.

(10) Indicators will have to be developed for the *technological level of SMEs* and its evolution over time.

(11) Environmental preservation is an integral part of SHD. Therefore, *indicators of environmental quality* and their evolution need to be constructed.

14. While all of these components of SHD are important for human welfare, some of them are more relevant than others for the manner in which countries integrate into the international economy. For these purposes, we will assume that the most important are: (a) sustained growth; (b) sustained increases in national investment and saving ratios; © the structural transformation of the economy in the direction of reducing subsistence, low-productivity sectors and increasing the importance of high-productivity, modern sectors; (d) diversification in the structure of exports; (e) increases in labour productivity and wages; (f) poverty alleviation; and (g) improvements in income distribution. These will be the main criteria against which a country's strategies of liberalization and integration into the world economy will be assessed.

III. INTERNATIONAL TRADE ISSUES

A. Trade policies at the national level: general considerations

15. At the outset, it must be recognized that initial conditions with regard to trade liberalization vary as between different developing countries. This will most likely be the case in countries participating in the UNCTAD/UNDP Programme. Some will have already completed a wide-ranging trade liberalization, others will be in the midst of such a programme, and still others will not have yet embarked in one. This will be true not only of trade but of all policy areas covered by this paper. The analytical framework provided here will clearly have to take into account the stage at which each country finds itself in the process of reform.

16. Whatever the point of departure, it is safe to say that the vast majority of low income countries have not been successful in launching a process of self-sustained growth, let alone one in which there are concurrent improvements in income distribution and poverty alleviation. Therefore, the objective of the programme will be to assist countries in identifying the complementary policies that are needed in order to put trade liberalization to work in spurring long-term growth, reducing poverty, and improving income distribution.

17. It is often assumed that trade liberalization, by itself, will result in a more equitable income distribution. This presumption is based on the notion that most developing countries have a relative abundance of unskilled labour and that the protected sector (manufactures) is capital-intensive. If this were so, trade liberalization would, by the Stolper-Samuelson theorem, raise real wages and depress the rate of return to capital. However, in actual fact, in many countries, the relatively abundant factor is land (or, more precisely, natural resources), and labour is second - sometimes a distant second - in the ranking of relative factor abundance. In such countries, the labour intensive sector is, indeed, manufactures. In such cases, trade liberalization tends to depress real wages. Although the creation of new comparative advantages is a goal of all countries, policies to achieve it will be particularly important in resource-abundant countries.

B. Trade and exchange rate policies: the essential relationship

18. Many developing countries have embraced trade liberalization as an important element in their development strategies. This is appropriate, as far as it goes. Most countries have very little scope for protection, in the sense that domestic markets are small and do not allow for the efficient production of a large range of goods. However, it should be remembered that prior to the 1960s, when import substitution was widely embraced as a development strategy, most developing countries had very liberal trade policies; none the less, no country was able to leave underdevelopment behind with free trade policies alone.

19. Moreover, policy makers are not always fully aware that the goal of liberalization is to reallocate resources, not mainly to traditional exports, but to new activities that create new

comparative advantages, be they exports or efficiently-produced import substitutes. There is enough historical evidence to warrant the generalization that trade liberalization, by itself, does not guarantee that fast growth or other constituent element of SHD will follow automatically from the dismantling of trade barriers. More purposeful policies to develop national capabilities will be required. If anything, this is the lesson to be derived from the more developed and successful countries of East Asia, where fast export-oriented growth has been accompanied by steep reductions in poverty and relatively equal income distributions, by developing country standards[2].

20. In fact, pure and unalloyed liberalization may, at least in the short to medium run, work against growth and some of the variables encompassed in the notion of SHD. For example, because in backward economies resources are extremely inflexible geographically and sectorally, the transition to a liberalized price system may be accompanied by a great deal of unemployment and an increase in poverty. Resources are eventually reallocated to export sectors, but with enormous losses of output during a transition that can be very drawn out. Moreover, in the absence of deliberate policies to foster it, the upgrading of the production structure toward technologically more sophisticated sectors may well fail to take place altogether[3].

21. The first conclusion that can be drawn from historical experience is that, in order to avoid transition problems and permanent damage stemming from the dismantling of trade barriers, the liberalization programme needs to be phased in gradually[4]. It is best to proceed in the following stages:

- Begin by reducing very high tariffs so as to eliminate "water" in tariff rates;
- Convert non-tariff restrictions into tariffs of a reasonable level; and
- Reduce very high tariffs first, then those at lower levels.

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[2] This is not the place to discuss the causes of the East Asian countries' success. Interested readers are referred to Amsden (1989, 1993, and 1994), Wade (1990), World Bank (1993), Yanagihara (1994), Lall (1994), Page (1994).

[3] For the Chilean experience, see Ffrench-Davis, leiva, and Madrid (1993); a review of the experience with trade liberalization in Latin America can be found in Agosin and Ffrench-Davis (1995).

[4] As noted by Toye (1999), sequencing in the phasing in of measures may also be needed in order to preserve fiscal balance and macroeconomic stability.

22. How long should the process take? The answer depends on a number of variables, including what happens to the exchange rate and the supply response of private agents to new incentives increasing the profitability of the export sector. In poor economies, markets are often segmented along regional or linguistic lines, which makes any process of sectoral reallocation of resources very difficult and sluggish. Moreover, diversifying into new products and becoming competitive in them requires investment, labour force training, and mastering new technologies, all of which are drawn out processes.

23. Should countries aim at a single tariff rate? Definitely not. Low income countries have inadequate capacity to produce capital goods and sophisticated inputs. These goods should have a zero tariff, because otherwise the capital formation process and the incorporation of new technologies would be penalized, and this is the last thing a country in need of growth should do. On the other hand, in most countries there is some scope for protecting some consumer goods with moderate tariffs. Tariffs also serve as important government revenue earners that are difficult to replace. Tariffs on consumer goods, particularly luxury goods, can also act as consumption taxes in economies where more sophisticated alternatives are difficult to implement. Therefore, two or three tariff levels should be optimal (Rodrik, 1992b).

24. The standard recommendation that trade liberalization is tantamount to a depreciation of the exchange rate and leads to larger exports is derived from a two-good model of the economy, with one importable and one exportable. This simplification ignores the fact that the most important sector in practically all economies is the one producing non-tradables (usually encompassing services but not restricted to them).

25. Once we introduce the non-tradable sector, the exchange rate takes centre stage. If the liberalization programme is to yield the desired results in terms of reallocating resources from importables and non-tradables to the sector producing exportables, the exchange rate must depreciate. In fact, it is possible to calculate the precise amount of the required real depreciation. The exchange rate must depreciate according to the following formula (see derivation in annex II):

where ê is the exchange rate[5] , t is the average tariff, a hat over a variable reflects percentage change, $_{x}$ and $_{m}$ are (average) export and import price elasticities, respectively, and h is the ratio of export to import value (in foreign exchange). If the depreciation does not occur, or is insufficient, the economy winds up producing more non-tradables and *less* exportables *and* importables. And that, clearly, is not the objective of policy.

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[5]Defined as units of domestic currency per unit of foreign currency.

26. In fact, in the absence of changes in capital flows, market forces will by themselves produce the required depreciation. This ceteris *paribus condition* is, or course, fundamental: in some cases, capital flows become endogenous to the success of the liberalization programme. The experience of several middle income countries (e.g., Chile, Mexico, Turkey)[6] suggests that this is because trade liberalization, especially when accompanied by other reforms viewed favourably in international financial markets, tends to attract large flows of financial capital to the reforming country, appreciating the real exchange rate. This is one powerful reason to maintain a tight lid on the capital account when liberalizing trade (more on this below).

27. Another important cause for fluctuating real exchange rates in developing countries is the heavy dependence of most countries on one or a few primary commodities whose prices exhibit a great deal of variability. The terms of trade of developing countries are much more variable than those of developed countries; moreover, developing countries are very vulnerable to the effects of terms of trade changes. One of those effects is a widely fluctuating real exchange rate, which renders uncertain the profitability of new exports and discourages investment in them. Moreover, highly variable foreign exchange availability is damaging to the investment process, which depends heavily on imported capital goods. A more stable availability of foreign exchange requires policies at the national and international level. At the national level, countries ought to constitute effective price stabilization funds, contributing to them in times of increasing prices and thus relieving downward pressures on the exchange rate[7]. When prices are below a benchmark level, the monetary authority would be entitled to draw on the fund, in this case helping to prevent excessive depreciation of the currency.

28. But exchange rate management is insufficient to ensure that domestic producers will reorient their activities toward producing for export markets. Other policies will also be necessary. Import duty drawbacks on inputs incorporated into export products are permissible under World Trade Organization (WTO) disciplines. It is also important to grant such drawbacks to indirect exporters, i.e. to domestic producers of inputs for exporters who themselves use imported inputs.

29. In low-income countries with small shares in export markets, export subsidies are still possible. A kind of moderate export subsidy that is highly efficient is one that is given to producers of new export products until exports reach a certain threshold, at which point the subsidy disappears automatically[8]. Higher income countries, for which export subsidies are prohibited, must devise more sophisticated ways of fostering exports, in areas that are essential to the success of the liberalization programme's goal to foster the emergence of new comparative

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[6] The case of Chile is analyzed in detail in the already cited paper by Ffrench-Davis, leiva, and Madrid (1993). For the cases of Mexico and Turkey, see Ten Kate (1993) and Uygur (1993).

[7] The way we have defined the exchange rate implies that a downward movement is an appreciation, an upward movement of depreciation.

[8] For the Chilean experience with this kind of subsidy, see Agosin (1997).

advantages and that are characterized by notorious market failures. These areas are technology, the quality of human resources, marketing, and investment finance.

C. Non-trade policies having a bearing on export diversification

30. Creating capabilities to participate in the international economy in a way that is conducive to SHD will involve a much more complex set of policy actions than the mere manipulation of policy instruments. These include the strengthening of SMEs, accelerating the transfer of technology and the development of indigenous technology, the construction of appropriate infrastructure, support in marketing efforts in key foreign markets, and the attraction of joint venture partners from abroad to assist in marketing and technological upgrading.

31. This is not intended to be the usual list of deficiencies that one can find in practically all developing countries. What is required is the elaboration of a coherent plan whose constituent parts are those items mentioned above and whose objective is to acquire comparative advantages in new areas that are able to support higher salaries and entrepreneurial incomes by SMEs. In the construction of such a plan, which ought to be undertaken in a fully democratic manner, the following stages are critical.

32. The first one is the identification of potential new comparative advantages. These new sectors or subsectors to be developed build upon a country's existing comparative advantages. The identification of new products for export markets is not meant to discriminate against existing exports but to allow the new ones to grow faster. Not much needs to be done to export what a country is already exporting. *A big push* is necessary to develop new production capabilities. The novelty of the SHD approach in the context of integration into the international economy lies in the emphasis that is given both to the international competitiveness and the incorporation into the process of broad segments of the population.

33. The identification of the sectors that merit development leads to the second step, which involves the evaluation of difficulties and bottlenecks in areas such as:

- Training and education;
- Technology absorption and development;
- Reaching consumers in key markets (product specification and quality, information requirements);
- Infrastructure needs (port and airport development, roads, electricity and telecommunications);
- ·Particular attention ought to be placed on ensuring that SMEs have adequate access to investment resources (more on which below); and
- Identification of technical assistance needs in all of these areas.

34. Some comments on these tasks may help illustrate the efforts that are needed and how different they are from mere trade liberalization. As already noted, in most of these areas market failure, incomplete markets, or non-existent markets are the norm. Innovation and on-the-job training are usually in short supply in all market economies (because the innovator cannot reap all the benefits of her actions and must bear all the costs). Some form of subsidization for the introduction of new technologies, the domestic development of technology, and the training of the labour force in new skills is indispensable if such activities are to be undertaken in a scale commensurate to the need for them. WTO subsidy rules allow for subsidies on innovation, training, and education, as long as the subsidies are potentially available to all producers and are not above certain limits (see GATT, 1993, Agreement on Subsidies and Countervailing Duties).

35. Another area that suffers from market failure is the effort to obtain information about foreign markets and the actions to actually penetrate foreign markets. Investment in information about consumer tastes in target markets, quality requirements, marketing channels, the technology needed to produce up to the standards of foreign markets may be too costly for individual prospective exporters (commonly small or medium-size enterprises). Moreover, the information obtained by a single producer can be used by another one who has not incurred the costs of obtaining it. These indivisibilities, externalities, and potential free riding problems of information gathering suggest the need for the involvement of a government agency or of producer associations (who must know what they are looking for, no small task!), which can then actually charge users the average cost of providing the information.

36. Policies to ensure adequate access to finance for SMEs which will have to do the investing that brings about structural change is perhaps the single most important complementary actions that governments will have to undertake. No subsidies are involved here. The question is not one of providing subsidized credit but of ensuring that SMEs, which are normally shut out of credit markets because they lack collateral, have access to financial resources at market-related interest rates. This will normally involve quite o bit of imagination and institutional innovation.

37. The third step is the preparation of an action plan to support growth centred on international competitiveness. For any plan to be successful, it will have to be elaborated and carried out with the participation of all interested parties. The UNCTAD/UNDP Programme can be of assistance in identifying the key bottlenecks and sharing best practice (and also worst practice) experience in other developing countries.

D. International trade negotiations

38. Although most of the countries participating in the project will have a small share in world markets and, as such, may not face severe market access problems, some definitely will. Therefore, it will be important for these countries to carefully evaluate their market access needs and prepare for future trade negotiations at the regional and multilateral level.

39. Liberalizing world markets for agricultural products, textiles, and footwear are tasks the Uruguay Round left unfinished. Low income countries can be expected to begin to penetrate new export markets in these goods. Another area of growing importance is the one related to *antidumping* procedures in industrialized countries. Many countries have encountered this form of protectionism, which is growing in incidence. It will be incumbent on them to prepare to make proposals (or support the proposals of others) to modify existing international disciplines in this area. Many of the countries participating in the project will require assistance in identifying negotiating needs in trade, finance, and FDI.

40. Most low-income countries already benefit from special and differential treatment (S&D) in some areas, particularly as regards export subsidies. Still, the concept of S&D suffered a major setback during the Uruguay Round and it has insufficient recognition in the WTO. It may be useful for developing countries to press for having it redrawn with a firmer hand, but with substantial modifications to prevent abuse. One can argue that reforming developing countries are, indeed, "infant exporters", and that the full brunt of international disciplines, in areas such as export subsidies or intellectual property (TRIPS) should not apply to them, *during the transition period to the launch of export oriented growth.* Thus developing countries that meet certain criteria (e.g. low income, unacceptable poverty levels, concentrated production and export structures) should be allowed temporary derogation from certain WTO disciplines.

41. The adoption of temporary S&D could be accompanied by strict criteria for graduation. In other words, the classification of a country as an "infant exporter" would not be a matter of self election. A change such as the one proposed here would give countries the degrees of freedom in policy making that they require in order to implement an SHD strategy.

42. Participation in regional integration schemes may be a particularly effective way of gaining new comparative advantages. Traditional exports normally go to industrial countries, and most developing countries do not have domestic markets of a size that is sufficient for producing many manufactures efficiently. The major role of regional integration is to develop new comparative advantages. But negotiating regional integration agreements, implementing decisions, and ensuring that partner countries live up to their commitments is no easy task for countries with very scarce human resources. Here again, countries could benefit from very focused technical assistance. The project could assist them in identifying needs in this regard.

IV. LABOUR AND FINANCIAL MARKETS

43. In the old literature on the sequencing of liberalization, it was often argued that domestic factor markets should be liberalized first, before attempting trade liberalization, simply because, in the presence of distorted factor markets, firms would not be able to respond to the new price signals emitted by liberalized goods markets[9].

44. Reality in developing countries is often more complicated than what the advocates of liberalizing factor markets assume. To give an example, it is true that, if firms are unable to fire redundant workers, or if firing is very expensive, the reallocation of labour will be more difficult than in the absence of such restrictions. Undoubtedly, rigid labour markets are not appropriate to poor countries where the reallocation of labour is difficult to begin with. But there are other, endogenous and not policy-induced rigidities that need to be removed. The new activities that might be stimulated by, say, lower tariffs *cum* exchange rate depreciation may require very different skills than protected manufacturing production. And these do not arise simply with passive policies[10]. More active policies are essential, and these are inherently more difficult, one reason being that most governments do not have the precise knowledge of what is needed and how to go about obtaining it.

45. The same can be said of domestic financial markets. It is true that in many countries domestic financial markets are repressed, credit at negative real interest rates often being directed to politically favoured clients. However, one suspects that this problem is much less intense today than it was, say, 20 years ago, when financial repression was typical of many if not most developing countries. Over the last couple of decades, many countries have undertaken domestic financial reforms, only to find out that financial market liberalization requires also a commensurate improvement in supervision and regulation, for which most developing countries are very inadequately prepared.

46. For other reasons as well, mere liberalization will be insufficient. Financial systems work notoriously poorly and tend to shut out of the market those firms that have neither reputation (usually large firms) nor collateral. SMEs are the ones that struggle hardest, and the ones that are most needed as active investors in a programme of structural transformation.

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[9]This view has come to be closely associated with the World Bank. For variants, see Edwards (1984), Michaely (1986), and Papgeorgiou, Choksi, and Michaely (1990).

[10]We label “passive policies” those policies which consists of basically eliminating policy-induced distortions. Sometimes, these policies are not easy to implement, but they are still passive in that they do not require that the government work to create new assets or capabilities.

47. Financing is also required for other purposes, and it is unlikely to be forthcoming simply by liberalizing. For example, as trade liberalization proceeds, workers that lose their jobs could become entrepreneurs. If financing is not available, this possibility is foreclosed. Financial innovation will be essential. Structural change will also give rise to demands for new and different kinds of human capital, the supplies of which will no rise spontaneously, owing to liquidity constraints to human capital investment. Markets fail notoriously in providing finance for education, again because the potential borrowers lack collateral, and there is no legal way for the lender to lay claim on the future income streams of the borrower should the latter fail to repay.

48. The question thus boils down to finding assets that can serve as collateral or ways to get around the need for collateral. For example, Ramos (1993) has suggested that workers' savings in social secur__y systems could be used as collateral for loans with the purpose of paying for their children's higher or technical education expenses. Toye (1999) cites examples from Bangladesh and Indonesia where collateral is made unnecessary through a series of devises which essentially attempt to bridge the asymmetry of information between lenders and borrowers that is an abiding trait of all credit markets. Risk-pooling through the use of a small fraction of loans for the purchase of insurance may also be of assistance.

49. It is clear that financial markets not only need to be liberalized. A good deal of institutional innovation will be required. Development banks could make an important contribution in breaking the financial bottlenecks that afflict most SMEs. As discussed below, in some countries that have a good credit rating in international markets, the development bank can act as an intermediary between international financial markets and the SME sector, passing on to SMEs the benefits of interest rates that are usually much lower in international than in national markets. Development banks do not need to be in the daily business of making loans; they can act as second storey banks, auctioning off specially earmarked funds to the banking system.

50. As noted by Díaz-Alejandro (1985) in his posthumously published paper, active use of development banks can greatly mitigate the failure of private financial markets to generate the volumes of financial resources required for development:

> *Latin American experience, and indeed that of continental Europe during the last century, makes one skeptical that private markets alone will generate a flow of financial intermediation high enough to support a rate of long-term fixed capital formation which fully exploits available high social rates of return to long-term investments... By providing long-term credit to new, non-traditional activities, development banks would eliminate one of the excuses frequently given for extravagant protection against imports.*

V. CAPITAL ACCOUNT ISSUES

51. We have argued that the trade régime for most developing countries, and particularly the low income countries, ought to be essentially liberal. Should the same be said about capital flows? Should capital flows be viewed simply as intertemporal trade, as some economists propose? Should some sequence be imposed on liberalization in the area of capital flows?

52. As in trade, developing countries come to this issue from very different points of departure. Some maintain varying degrees of control over capital flows. Others have never had them. Still others have recently undergone extensive capital account liberalization, only to find that their rates of growth have become more closely linked to the ebbs and flows of international finance. We shall argue that some forms of control over capital flows are desirable. Those countries that still have them should be quite circumspect in liberalizing their capital accounts entirely; those that do not apply capital controls ought to retain the right to put them in place should the situation require it. The experience of different countries should be useful in this respect.

53. In recent years, developed countries have attempted to bring the issue of liberalizing capital flows to the arena of trade negotiations within WTO and have pushed for such liberalization in other fora, especially in the OECD, inviting developing countries to subscribe a Multilateral Agreement on Investment (MAI) that they have had no part in negotiating. How should developing countries approach this issue?

A. National policies towards the capital account

54. We first deal with national policies, to take up next the issue of international negotiations. Of course, both sides of the coin cannot be adequately dealt with separately, since from the moment one advocates the notion that some controls are appropriate, this has immediate implications for international negotiations.

55. We argued in the foregoing section on trade policy that maintaining an appropriate level of the real exchange rate and avoiding excessive exchange rate fluctuations were *sine qua non* requirements for the successful launching of a competitiveness-oriented development strategy. In most countries, the exchange rate is determined largely by capital movements, and, as already noted, by fluctuations in the terms of trade. Since certain types of capital flows can be large relative to the size of the economy and can also be extremely volatile, in order to maintain the exchange rate at a level that supports the diversification of production and exports, it is extremely advisable that full capital account liberalization be eschewed while a policy of opening up to trade is being implemented. Capital account liberalization should not be undertaken until the domestic corporate sector is strong enough to withstand sharp exchange rate fluctuations and the banking sector has been strengthened and appropriately regulated. Both of these tasks are normally achieved very late in the development effort.

56. It is thus better not to open the capital account of the balance of payments as regards non-trade credit lending to the private sector and portfolio investments. Both of these forms of capital are very volatile and can be dangerous to a fragile developing economy. Most lending to the private sector is essentially short-term, and banks can easily fail to roll over credits at the first sign of trouble. Portfolio investments are not usually thought of as short-term, but they really are. Most portfolio investors (purchasers of stocks and, in those few countries where they are available, bonds) typically seek short-term appreciation in their home country currency and high liquidity. Financially fragile economies such as those of most developing countries stand more to lose than to gain from this kind of "investment". As shall be argued below, there is a role that portfolio investment can play, but it needs to be regulated in order to avoid excessive volatility.

57. International finance undoubtedly has numerous microeconomic benefits for borrowing countries: it allows them to decouple investment from national saving and it helps in smoothing consumption patterns when countries are faced with external shocks. However, these benefits must be weighed against the negative macroeconomic externalities associated with some forms of international finance.

58. International financial flows are undertaken by numerous agents with widely differing objectives and time horizons[11]. These run the gamut of foreign direct investors with long time horizons and large sunk costs to portfolio investors and interest-arbitraging agents who invest only in highly liquid instruments. It is these latter that cause difficulty, since they tend to be extremely skittish, subject to sudden changes of mood and to herd-like behaviour, basically owing to the asymmetric (and incomplete) information that characterises financial markets in general and financial flows to emerging market countries in particular[12].

59. Financial markets are inherently unstable, because asset prices are determined by expectations about future returns, and these are essentially unknown. Even in the case of fixed income securities and non-securitized lending, there are several sources of uncertainty about future yields which render security prices unstable and which could lead to changes in the assessment of lenders about the desirability of renewing short-term loans to borrowers.

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[11]There are differing views on this issue. Claessens et al. (1995) argue that it is impossible to differentiate the behaviour of what the IMF classifies as foreign direct investment (FDI) from that of other types of flows. However, an analysis for Chile (Agosin and Ffrench-Davis, 1997) shows that FDI is much more persistent and has much less variance around its time trend than portfolio flows or short-term lending. As Radelet and Sachs (1998) point out, in the financial crises of the 1990s, FDI has been quite stable, and all the volatility has been due to the behaviour of short-term lending and portfolio flows.

[12]See Calvo and Mendoza (1996) for a plausible model of portfolio investments in EM used to explain the Mexican 1994 crises.

60. This is all the more the case in financial transactions between creditors in developed countries and debtors in developing countries, where the sources of risk are particularly varied and the degree of risk associated with each is especially high. In developing countries, exchange rates and interest rates tend to be highly unstable, and individual firms and banks have sources of fragility not found in the developed world. Therefore, the continuous changes in information that normally occur in any market economy are exacerbated when it comes to developing country settings, and these can produce excessive volatility in flows to and from these economies[13].

61. These considerations suggest that the best approach to capital account liberalization is one of caution. In the same way as an optimal sequence for liberalization exists as between the current and the capital accounts, there is also an optimal sequence *within* the capital account. FDI represents the least danger for countries undertaking reform. In fact, FDI, under certain circumstances, can make a contribution to the structural transformation of the economy. Therefore, it should be liberalized first. Long-term suppliers' credits for the purchase of capital goods are also a good candidate for early liberalization. But it is best to close off the national banking system from international financial markets; adequately supervised public national development institutions ought to intermediate between private national banks and international capital markets. Finally, the liberalization of domestic stock purchases by foreigners should be left for a very late stage in the development process.

62. An exception to policies to close off access by national banks to international financial markets can perhaps be made for trade credits, which, in low income countries, have traditionally been the domain of transnational banks operating in their domestic markets. It should be recognized, however, that money is fungible and that it is not always possible to place different items of the capital account in water tight compartments. Controls on capital movements involve not only the possibility of leakages and fraud, but also an inevitable price in terms of microeconomic efficiency. However, they are indispensable in order to safeguard the economy from the serious negative macroeconomic externalities involved in wholesale liberalization. The problem is clearly more acute in middle-income than in very low-income countries, where private capital flows are likely to be small relative to GDP. Clearly, the management of the capital account represents one of the most difficult challenges to developing countries. But it is essential for a successful SHD strategy that seeks to deepen ties to the real side of the international economy.

63. We thus posit that there is a conflict between trade integration into the international economy and financial integration, and that countries must choose which one they prefer. An SHD strategy involves giving primacy to trade integration.

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[13]See Agosin (1999) for a more developed argumentation.

64. There are two types of departures from capital account liberalization that ought to be distinguished. In the first place, restrictions can be placed on inflows and on outflows. Restrictions or disincentives on inflows may be necessary in order to prevent future crises. Restrictions on outflows are required in order to minimize the damage caused by a crisis that is already under way. Then there is the distinction between market-based measures (which affect the effective interest rate at which domestic agents can borrow abroad) and quantitative restrictions. The former are more suited to controlling inflows than outflows. The latter are particularly useful in times of crisis.

B. Is there a role for portfolio capital in fostering SHD?

65. The participation of foreign capital in domestic equity and bond markets is best handled through special vehicles rather than directly. Several developing countries have considerable experience in this regard and allow, for example, individual equity funds to participate in domestic equity and bond markets, with limits on their participation in the equity of individual companies. Closed- or open-end funds can also be created to channel resources into promising private investments and venture capital projects. Where private financial markets have a reasonable degree of development, and where regulation and supervision of financial intermediaries is reasonably good, such activities can be entrusted essentially to the private sector, the authorities retaining the role of regulators to ensure that the excesses endemic to financial markets are not committed.

66. In countries with undeveloped financial markets, specialized development banks can play a role in setting up funds the objective of which would include long-term lending to and taking up equity stakes in promising SMEs. These banks can tap international markets for resources with which to jump start these funds. The International Finance Corporation (IFC) and other multilateral and regional institutions can provide initial financial resources, assistance to countries in tapping international financial markets, and technical advise. In fact, supplementing and completing domestic capital markets could have important pay-offs in terms of SHD and should become one of the major forms of official development finance in the years to come.

67. Infrastructure is one of the most serious bottlenecks to development. The capacities of governments to design efficiently infrastructure projects and to fund them are often the biggest stumbling blocks to solving this problem. As regards the financing, one novel approach could consist of creating specialized funds for investing in privately built and operated infrastructure works. Infrastructure funds can be operated by a development agency which would tap international markets for financing; or, in countries with more developed financial markets, this role could be performed by private managers. In both cases, technical assistance from institution such as the IFC may be important. Where necessary, aid agencies and the soft loan windows of the multilateral development banks can provide the technical and financial assistance for the design and engineering of the required infrastructure projects.

C. International negotiations regarding the capital account

68. Liberalization of capital account transactions has been a policy thrust of the major developed countries pursued insistently in recent years in a number of forums, including the OECD, the World Trade Organization (WTO), and the IMF. There is a certain degree of contradiction and overlap in the negotiations at the OECD on the drawing up of a Multilateral Agreement on Investment (MAI), the recently approved WTO Agreement on Financial Services, incipient discussions in WTO with regard to the adoption of a Multilateral Framework for Investment (MFI), and suggestions that the IMF should adopt convertibility of the capital account as a major policy objective for its members (see Agosin, 1998b). Although the MAI is being negotiated only among OECD member countries, it would be open to signature to all countries.

69. The discussions in different forums differ as to the coverage of the contemplated disciplines on domestic policy and the approach taken with regard to commitments. While the MAI and capital account convertibility in the Fund would cover all capital account transactions, the MFI would apply largely to FDI. While the MAI has a negative list approach to liberalisation (everything is liberalized unless a specific waiver is obtained), the WTO Agreement on Financial Services has a positive list approach (only what is specifically offered is liberalized). The draft MAI, as it now stands, has absolutely nothing to say on key issues of interest to developing countries, including the responsibilities of TNCs to host countries and the granting of incentives to foreign firms. Presumably, the discussions in the WTO, where developing countries are represented, would deal with these issues.

70. As already argued in this paper, prudential regulation on international capital movements may be necessary in order to avert large macroeconomic costs in countries that are not ready to adopt full capital account convertibility[14]. Recent papers on disincentives to short-term capital inflow show that they can be successful in limiting the size of total inflows and changing their composition toward the more desirable longer-term flows (see Agosin and Ffrench-Davis, 1997; and Barrera and Cárdenas, 1997). Even if they do not use it, developing countries should retain the right to impose capital controls on outflows, particularly in times of crises. Therefore, Fund policy ought to recognise that developing countries and transition economies are simply unprepared to liberalise their capital accounts and should stop insisting that they do so. From the point of view of developing countries, the worst outcome would be for capital account convertibility to become another item in the list of conditions attached to the use of Fund resources. If the MAI is ever approved by the OECD membership, it should not be signed by non-OECD members unless it also enshrines this flexibility.

[14] The term “prudential” , which is borrowed from banking regulation and supervision, is not usually associated with international capital flows. However, given the volatility of certain kinds of capital flows and the widespread contagion effects that have recently become evident, national controls on international capital movements do , in fact, acquire a prudential nature. The use of capital controls and disincentives for the purpose of improving the effectiveness of macroeconomic management, banking supervision and regulation, and corporate governance is discussed at length in UNCTAD (1998, pp.101-105)

71. It is often argued that, in practice, it is difficult to distinguish between FDI and other types of flows, because a large part of FDI is akin to portfolio investments. Mergers and acquisitions of parts of existing firms' assets are, nowadays, more important than greenfield investments, and divestments are as frequent as investments. On the other hand, reinvested earnings also represent a large part of total FDI, and these are often invested in liquid assets or even in the stock market of the host country (Kozul-Wright and Rowthorn, 1998). Moreover, TNCs are able to move funds in and out of markets in ways that national firms cannot. While all of this is certainly true, it still seems worthwhile retaining the distinction between FDI and other flows. It has already been noted that statistically recorded FDI has been much more stable than other flows during the current financial crisis. And, of course, there is no reason why the financial transactions of TNC affiliates cannot be treated in the same manner as all other international financial transactions and made to comply with regulations applying to national agents.

72. There are other issues that merit consideration when it comes to international policies toward the capital account[15]. Since developing countries are particularly vulnerable to external shocks - be the on the current or capital account side - it is important for them that international arrangements protect their development efforts from derailing owing to circumstances beyond their control. The current financial crisis has made it clear that the International Monetary Fund has not been an effective instrument in containing the spread of the crisis or assisting affected countries to surmount it as speedily as possible.

73. In order to be of greater assistance to developing countries in this regard, the Fund should lend more liberally to countries affected by contagion. For countries experiencing contagion from the side of trade, the Fund ought to be willing to use more liberally its Compensatory Financing Facility (CFF), created expressly for that purpose but which has fallen into disuse in recent years. Primary commodity producers are the prime candidates to draw more actively from the CFF.

74. However, the bulk of the demands on the Fund in times of financial crises will come from countries experiencing capital account problems. Therefore, the Fund should create a new facility for countries experiencing financial contagion - call it the Financial Crisis Facility (FCF)[16]. This facility would provide financing for countries experiencing contagion but exhibiting sound fundamentals - i.e., meeting pre-established criteria of soundness.

[15]For a more articulated discussion of these issues, see Agosin (1999).

[16]See UNCTAD (1998, pp.87-88) and IMF (1994). For discussions of this issue, see Fitzgerald (1996) and Williamson (1996).

75. These reforms would require a large increase in Fund resources. These can come from larger quotas, enabling the Fund to borrow on international financial markets, or allowing it to create SDRs in times of financial crisis[17].

76. The Fund also needs to take a new look at its conditionality policies, which are designed for situations in which a country has gotten into trouble owing to overly expansive macroeconomic policies or inappropriate exchange rates. Conditionality should continue to operate when the source of the applicant's problems is in fact inappropriate macroeconomic policies. But it should not be imposed on countries suffering from contagion on current or capital account. The introduction of structural reforms, particularly in times of financial crisis, should not be a condition for drawing on Fund resources, and neither should capital account convertibility.

VI. POLICIES TOWARDS FDI

77. It has already been suggested above that policies toward FDI ought to be liberalized ahead of those toward other items in the capital account. The reason is that, potentially, FDI can make an important contribution to SHD (see also Chudnovsky and López, 1999). FDI is often valued for its contributions to capital formation, access to new export markets, training of the labour force, potential backward and forward linkages, and introduction of new technologies and managerial skills. Of course, not all FDI does so. Some foreign investments may displace domestic entrepreneurs or domestic investment. Others may fail to contribute significantly in any of the dimensions noted. However, all things considered, a liberal policy toward FDI is more likely to have favourable effects on development than a restrictive one. Many developing countries do not possess the human resources or governmental capabilities to design and manage a successful selective policy toward FDI. In these countries, selective policies are more likely to discourage potential investors than discriminate between better or worse projects. In these countries, best policies are those which establish clear and stable rules of the game and national treatment at the post investment stage. Performance requirements and special incentives ought to be used sparingly, they ought to be as simple as possible, and they should be tailored to the ability of countries to manage them.

78. Countries with greater experience in managing FDI policies can afford to apply more selective policies. Since the objective is to *attract* foreign firms, selectivity should not be implemented via controls, which are more likely to discourage investors generally. There are several ways of putting in place selective polices that are market friendly. For example, firms that train their labour forces, carry out research and development, develop local suppliers and subcontractors, assist

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[17]See Ezekiel (1998) for a proposal to use SDR creation to deal with financial crises.

local suppliers with the upgrading of product quality or technology, could be allowed to discount from their taxable income a certain multiple of the expenses incurred in carrying out these socially desirable tasks. Of course, these incentives should also be open to national companies.

79. Even within a basically liberal approach to FDI, much can be done to attract desirable firms. The essential component of a policy toward FDI that fits with an SHD strategy is to define the basic building blocks of the development strategy. For this, policy makers need to have a clear idea of what clusters of activities have a good chance of arising in the next stage of gaining comparative advantages, and, therefore, which activities should be promoted. This will determine needs for the development of human resources, infrastructure requirements, etc. Then policy makers can in fact attempt to target firms that present the most desirable characteristics and ask of them what is it that they need to invest in their country. A very good example of this kind of effort is the success of Costa Rica in attracting INTEL to build a US$ 500 million dollar semiconductor plant that will change the profile of Costa Rican production and exports and will have significant backward linkages to the rest of the economy (ECLAC, 1998, pp. 48-49).

80. Official development assistance (ODA) can also be very important in helping countries attract the FDI they require for the implementation of a SHD strategy. Often FDI is not attracted to developing countries because a large number of complementary inputs are not to be found in these economies. Perhaps the most important ones are infrastructure (roads, ports, airports), human resources, and public utilities (telecommunications and electricity). As noted above, some of these needs can be addressed through novel ways of mobilizing private financial resources from international markets. But in the poorest countries, ODA will remain essential.

VII. CONCLUDING REMARKS

81. SHD is a complex goal requiring complex policies. Their very complexity is already an indication that they may be difficult to design and implement in low-income countries. Therefore, policy makers have to be objective as to the capabilities of national institutions, both public and private. This argues for identifying key bottlenecks and working on them, using wherever possible market solutions that economize on centralized decision making.

82. In the context of SHD, liberalization should be seen as a tool, not as a goal in itself. Our contention is that, while in many instances, appropriate liberalization will almost never be enough. In some cases, in fact, it may not be desirable. This is particularly the case with capital flows.

83. Liberalization is a passive policy approach consisting in dismantling market distortions. SHD will also require *active* policies to build supply capabilities and strong supply responses to price signals, in a way such that sustained growth, structural change, poverty alleviation, and improvements in income distribution might be achieved. While the situation will vary from country to country, the key areas to work on are improving and supplementing domestic capital markets, technology acquisition and development, training and higher and technical education, the acquisition of information on foreign markets, and the development of new infrastructure.

84. National policies must be accompanied by support at the international level. Therefore, countries must become aware of what policies at the international level in the fields of trade, investment, and finance will be supportive of SHD. This will allow them to participate more actively (an, hopefully, successfully) in international negotiations.

85. The objectives of the UNCTAD/UNDP Programme are twofold. On the one hand, low income countries need to become better aware of their needs in the area of market-oriented reforms, their sequencing, what to liberalize and what to postpone liberalizing. On the other hand, the Programme aims at assisting countries in identifying the specific supply side bottlenecks to SHD. It is hoped that countries will benefit from the Programme not only through the provision of high-level consultancy resources, but also from the exchange of information on how other countries, some of which are also participating in the Programme, have dealt with the same issues. In fact, at a global level the Programme has the objective of gathering information and analyses on experiences with regard to integration into the international economy and making them available to all interested parties.

86. The formulation of a plan of action will follow from the analytical work. This must be a task of the entire society, involving not only government but also the enterprise sector, workers, and academics. This is, in a sense, the hard and long road to development. It is hoped that this Programme will assist countries in getting this process started.

ANNEX I

A FRAMEWORK FOR COUNTRY ASSESSMENT STUDIES

87. It is important to understand the sort of work that the programme wishes to foster at the country level. The objective is to set in motion a *process* leading to rapid sustainable human development. Under contemporary conditions, this is not possible except through integration into the world economy. However, not all such integration necessarily leads to SHD. Therefore, the basic idea is to foster a kind of integration that does result in sustained rapid growth, reductions in poverty, improvements in basic social indicators, preservation of the environment, and the economic advancement of women.

88. While documents and reports will emerge from work at the country level, their production is not to be considered the main objective of the programme. The documents that do arise should be very policy-oriented and should assist not only the authorities of the country in question but also those of other countries in similar situations. The real objective is to stimulate a process of policy dialogue among the main actors in society (business leaders, labour, SME sector, government, civil society) in which the UNCTAD/UNDP input will play a catalytic role. This dialogue will hopefully lead to work in policy design on specific issues which undoubtedly will vary from country to country.

1. Situational analysis

89. The first task of work at the country level will be to assess the extent to which SHD objectives are being met. The following list is certainly not all-inclusive. It is intended solely as a guide to what to look for.

- GDP and per capita GDP growth, in comparison with other countries of similar characteristics;
- Evolution of income distribution and poverty measures;
- Evolution of other indicators of SHD (life expectancy at birth, school enrolment indicators, gender-related indicators);
- Investment rates and growth, total and by sector;
- Evolution of unemployment rates, by sector and region;
- Employment growth, total, by sector and region;
- Evolution of real wages and labour productivity;
- Export volume growth;
- Export profile and evolution over time;
- Export concentration indices (Hirschman-Herfindahl index, share of three top exports); and
- Growth of non-traditional, non-subsistence sectors of the economy;

2. Opportunities and risks arising from integration into the world economy through trade

90. In some cases, the country in question will have undergone significant integration into the world economy. It will be essential to have a clear picture of what has been done in this regard and what are the tasks that still remain. The link between integration into the world economy and SHD should be kept firmly in mind in undertaking this assessment.

A. Trade policy

- Initial conditions and definition of policy objectives in the area of reducing tariffs and tariffication of non-tariff barriers to trade;
- Identifying the sequence of policy actions;
- Assessment of how are duty drawback schemes working, if they exist; suggestions for their introduction, where they do not exist; and
- Design of export subsidies, where these are allowed under WTO rules.

B. Regional integration schemes

- Evaluation of existing schemes: problems and degree of advance;
- Changes in trade and investment flows associated with regional integration; and
- Evaluation of regional integration arrangements from the point of view of SHD.

C. Exchange rate policy

- Evolution of real exchange rate, pre and post reform;
- Main factors driving exchange rate; and
- Is the exchange rate supportive of transformation in the structure of production and trade?

D. Non-trade policy requirements for changing comparative advantages: evaluations of policy design and results

Here again, the objective would be to take stock of the policy infrastructure that exists, the lacunae that remain, and the actions that might be undertaken in each area. Different country exercises may pay special attention to different items on this list, in accordance with the priorities of policy makers and other civil society participants in the exercise.

- Have the authorities developed a coherent plan to promote exports of new products? Overall evaluation of strategy to improve supply responses;
- Indicators of training pre and post reform;
- Training policies at the firm level: evaluation of subsidy schemes for on-the-job training;
- Technology policies: indicators of technological efforts pre and post reform;

- Evaluation of national technology policies;
- Evaluation of marketing efforts at national level: subsidies, formation of producer co-operatives and fostering of joint efforts;
- Evaluation of infrastructure needs and advances; and
- Achievements, lacunae, and policy recommendations.

E. Assessment of trade negotiation needs

- Multilateral trade negotiations;
- Regional integration schemes.

3. Domestic labour and financial markets

91. The key to combining successfully SHD and integration into the world economy is to be found in appropriate supply responses to changing market signals. And this is intimately related to strengthening the SME sector of the economy and upgrading labour skills. The reason these tasks are so difficult is that factor markets usually fail in developing countries.

92. The country assessments will seek to identify needs with regard to institutional innovation in domestic factor markets. Whereas in some cases a dose of liberalization will be appropriate (where, e.g., there is a great deal of financial repression), in most cases the overwhelming need will be for institutional innovation that ensures that (a) labour and financial resources are reallocated from hitherto protected sectors to activities with potential comparative advantage; (b) workers do not bear the brunt of adjustment costs, and (c) SMEs are able to access needed investment resources. In most cases, improvements in the operation of labour markets will involve innovation in financial markets.

A. Labour markets

- Labour market reforms, where needed;
- Measures to improve the mobility of labour: retraining facilities, relocation loans, lending for starting up new small businesses; and
- Unemployment insurance: does it exists, how it works? Where it does not exist, is it feasible from a fiscal, institutional, and political-economy point of view?

B. Financial markets

- Assessment of institutions providing financial resources to SMEs;
- Feasible new schemes to improve the provision of investment resources to SMEs;
- Possible role of development banks: modes of operation, how to supervise and regulate them; and
- Assessment of technical assistance needs in this area.

4. Financial flows and development

93. As in the case of trade policy, participating countries will have different points of departure. Some will be utilizing various forms of capital controls, others may have never done so, and still others may have recently implemented liberalization policies in this field. In all cases, the thrust of the exercise will be to examine what are the requirements for SHD in the area of capital account policies. In cases of countries that have liberalized their capital accounts, it will be important to evaluate the extent to which this did contribute to growth.

A. Policies toward the capital account

- FDI régime pre and post reform: what is allowed, extent to which FDI is directed to specific uses, incentives and performance requirements; and
- Policies toward other items of the capital account, pre and post reform.

B. Financial flows pre and post reform

- Evolution of financial flows pre and post reform;
- Evaluation of capital account reform and suggestions for change.

C. Tapping portfolio flows for SHD

- Have there been any initiatives to tap international finance to build up a venture capital markets or greater private equity financing? and
- Recommendations in these respects.

D. Assessment of technical assistance needs in international financial negotiations

5. FDI: How supportive of SHD?

94. This section will require the elaboration of a survey to be applied to a sample of foreign affiliates operating in the country. Such an effort will be justified wherever the participating country attaches special importance to its FDI policies.

A. Growth and sectoral distribution of FDI, pre and post reform

B. Contribution to capital formation

- Are TNCs located in sectors unlikely to be developed by domestic firms?
- Does FDI take the form of M&A or of greenfield investments? and
- Share of reinvested earnings in FDI.

C. Contribution to diversifying exports

- Are TNC affiliates located in new export sectors, which domestic firms are unable to develop because of technological or market access reasons?
- Do TNC affiliates contribute to "indirect" exports by purchasing inputs in the domestic economy?

D. Technological contribution

- Training by TNCs, pre and post reform;
- Introduction of new technologies by TNCs;
- R&D by TNCs, pre and post reform;
- Do TNCs establish "deep" relationships with domestic subcontractors?
- Do they have subcontractors?
- Do they train them in matters such as quality of supplies?
- Do they supply technological knowledge to them?
- Do they take up equity positions in subcontractees? and
- Has this pattern changed as a consequence of policy?

E. Overall assessment of FDI policy and suggestions for policy change

6. Assessment of the degree to which reforms of trade, finance, and FDI régimes are supportive of SHD

95. This section of the assessment will consist of a wrap-up and will spell out the policy conclusions of the exercise.

A. How coherent have the policy reforms been?

- Depth of trade policy reform: changes in tariffs and non-tariff barriers;
- Coherence between trade policy reform and exchange rate policy; and
- Assessment of other measures to support export oriented growth.

B. What have been the results of the policy reforms?

- Have the policy reforms resulted in achievement of SHD objectives?
- In which areas has there been a greater degree of success and which areas are lagging?
- Assessment of results obtained; and
- Influence of exogenous factors on growth (deteriorating terms of trade, financial crisis).

C. Policy recommendations

- Measures that need to be taken to strengthen SHD in the context of integration into the international economy;
- Correcting the errors in policy;
- Errors of omission: what policies are still lacking in order to improve SHD performance?

ANNEX II

DERIVATION OF THE COMPENSATORY DEPRECIATION

96. Assume that, to start out, the economy is in balance-of-payments equilibrium. Letting F* be equilibrium capital flows, the balance-of-payments equilibrium can be described as follows:

(II-1)

where asterisks denote international prices (assumed to be independent of the levels of trade of our country).

We can differentiate (II-1) to obtain:

(II-2)

Under the small country assumption, the price for the importable and exportable are, respectively:

(II-3)

where t is the (ad valorem) tariff and e is the nominal exchange rate ("pesos" per "dollar").

By the definition of elasticity, we obtain expressions for dqx and dqm:

(II-4)

where a hat over a variable denotes percentage change.

Replacing (II-4) and (II-1) into (II-2):

(II-5)

where h is the ratio between the value of exports and the value of imports expressed in foreign currency.

If the current account is in balance to begin with, (II-5) reduces to:

(II-5a)

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