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# **Financial Openness and Employment: The Need for Coherent International and National Policies**

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*Abstract:* External financial liberalization has led to a surge in international capital flows since the early 1990s. While the direct growth benefits of financial openness are unclear, it has led developing countries to engage in costly reserve accumulation on an unprecedented scale. Although this offers some protection against financial crises, many developing countries have nonetheless experienced greater economic volatility and full-scale financial crises since the early 1990s. These crises have had a considerable impact on GDP and long-term growth prospects, but it appears that labour has suffered disproportionately as labour market indicators typically lack economic recovery. Furthermore, the labour share in national income is typically eroded during a financial crisis. The present paper, therefore, draws the conclusion that volatility in international financial markets is currently perhaps one of the most harmful factors for enterprises and labour in developing countries. Hence, the paper suggests how greater policy coherency between international and national financial, economic and employment policies can give greater attention to employment and incomes.

*JEL classification:* F43; G15; J21

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# Financial Openness and Employment: The Need for Coherent International and National Policies\*

“The consequences of mistakes in financial markets, where capital is volatile and mobile globally, far exceeds the consequences of mistakes in the labor markets, where labor is largely immobile across national lines”

Richard Freeman, *Responding to Economic Crisis in a Post-Washington Consensus World: The Role for Labor*, May 2003.

## 1. Introduction: Some Characteristics of Financial Openness

The current wave of globalization is characterized by a more liberal policy stance at the international and national levels. While policy for trade liberalization dominated the international agenda since the 1960s, policies for financial liberalization have been of a much more recent vintage. They have been applied in the wake of stabilization and adjustment policies which characterized the 1980s and early 1990s. The major expected result from financial liberalization was that it would allow (developing) countries to utilize resources better and to increase capital formation, through stimulating foreign direct investment (FDI) and other international capital flows such as private portfolios investment. A more open national financial system was seen as a necessary complement to the lifting of impediments to international capital flows. Over the past two decades, many countries have liberalized their capital accounts (see Lee and Jayadev 2005) and almost all policy measures related to foreign direct investment favoured a more open regime (see Annex Graph 1 and 2).

As a consequence, capital has become globally mobile – in contrast to labour, whose movement is still highly restricted.<sup>1</sup> International capital flows accelerated especially since the mid-1990s. Worldwide gross private capital flows (the sum of the absolute values of foreign direct, portfolio, and other investment in- and outflows) have been equal to more than 20 per cent of world GDP for the past seven years, compared to less than 10 per cent of world GDP before 1990 (see Annex Table 1). Worldwide FDI flows, a sub-category of private capital flows, also rose substantially during the 1990s and equalled 4.9 per cent of world GDP in 2000. They have since declined, but they are still well above the level of the

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<sup>1</sup> Although labour migration has gained importance, the world’s approximately 86.3 million migrant workers accounted for only 3.1 per cent of the economically active population in 2000 (based on ILO 2004a, p. 7, and the ILO database Laborsta, EAPEP, Version 5).

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1980s or 1970s. Yet, despite this substantial increase in capital flows, a number of worrying trends remain:

- i.** *During the surge in foreign capital flows since the 1990s, actual investment into new infrastructure and productive capacity stagnated.* Gross fixed capital formation (the most commonly used measure for physical investment) equalled 22.0 per cent in 2000 (the year when international capital flows peaked), only marginally above the level of the early 1990s (see Annex Table 2 and Graph 1 below). This divergence in trends can in part be attributed to the fact that much FDI was spent on mergers and acquisitions, and did not go into new factories or machinery.<sup>2</sup> Despite the widespread perception of an investment boom during the 1990s, increased cross-border flows have not increased the overall level of investment. Gross fixed capital formation was on average actually lower since 1990 than in the 1980s or the 1970s.<sup>3</sup> It is thus not surprising that world GDP growth, too, was slower than in previous decades (see also Graph 2 below).
- ii.** *Cross-border capital flows are still largely a phenomenon of developed countries.* In 2004, gross private capital flows equalled 28.4 per cent of GDP in high-income countries, but only 11.9 per cent of GDP in low- and middle-income countries (see Annex Table 1). While there was a positive balance between in- and outflows for developing countries as a group, these flows by-and-large bypassed the poorest countries since the early 1990s as over 90 per cent of the net inflows went to middle-income countries (see Annex Table 3). FDI, as well, is highly concentrated among industrialized countries and a small group of middle-income countries (see Annex Graph 3). Low-income countries therefore still draw, to a large extent, their foreign resources from official development assistance which, despite lofty statements at various international fora, has not increased in the past 15 years.<sup>4</sup>
- iii.** *International capital movements have led to greater economic volatility, a trend that has been well documented* (Diwan 2001; Prasad et al. 2003 and 2004; Cerra and Saxena 2005). Most research points to the direction that volatility in turn has led to more frequent financial and economic crises in developing countries (while this is not necessarily the case for industrialized countries) (see Easterly et al. 2001; Singh 2003). Such crises have negative effects on growth, investment and incomes, not only in the short term, but also in the long run (Diwan 1999 and 2001; Cerra and Saxena 2005). Hence, volatility and financial crises that are caused by financial integration should be seen as a serious problem for enterprises and labour – contrary to earlier views that, with proper national institutions and so-called safety-net programmes, countries would be able to withstand the medium- and long-term negative aspects of volatility and crises.

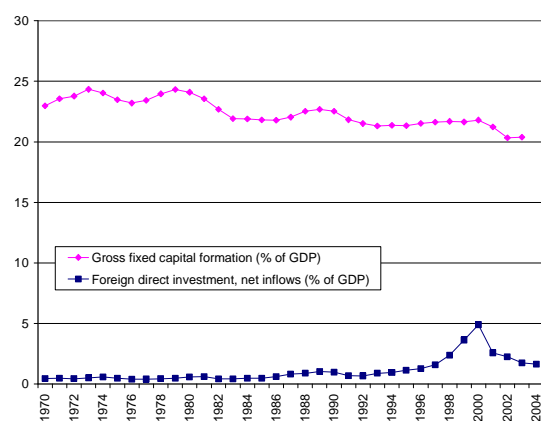
<sup>2</sup> UNCTAD data show that the FDI boom was in part driven by mergers and acquisitions: From 1998 to 2001, total cross-border M&A sales were equal to more than 70 per cent of total FDI outward flows, up from less than 50 percent between 1992 and 1994. See UNCTAD (2004b: Annex Table B.7.) and UNCTAD (2004a).

<sup>3</sup> The respective figures are 21.7 per cent of GDP (1990s), 22.5 per cent of GDP (1980s) and 23.8 per cent of GDP (1970s). See World Bank (2005a); based series “Gross fixed capital formation (% of GDP)”.

<sup>4</sup> Official development assistance and official aid (ODA/OA) to all low- and middle-income countries actually declined through most of the 1990s, falling from 65.5 billion current US\$ in 1991 to a low of 52.3 billion US\$ in 1997. The recovery thereafter brought it back to 65.3 billion US\$ in 2002 and to 76.2 billion US\$ in 2003. Despite this nominal increase, ODA/OA was about equal to its 1991 level in real terms in 2003. See World Bank (2005a); based on series “Official development assistance and official aid (current US\$)”.

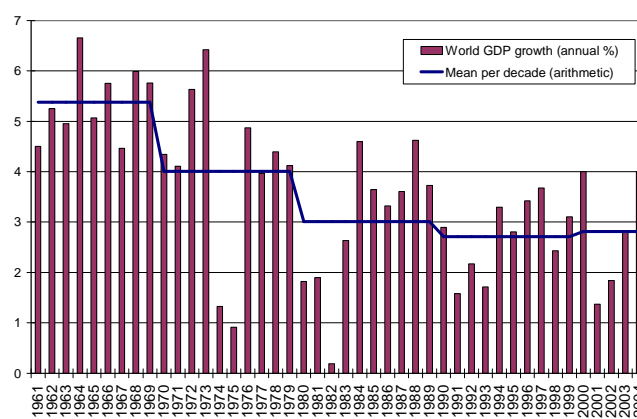
In the light of these trends, the purpose of this paper is to review the effects of financial liberalization on employment and incomes. The paper will concentrate on the effects of volatility and crises on labour that is primarily associated with debt and portfolio equity flows, and less with FDI flows.<sup>5</sup> The paper is motivated by the concern expressed by the World Commission on the Social Dimension of Globalization that “[g]ains in the spheres of trade and FDI run the risk of being set back by financial instability and crisis” (WCSDG 2004: 88). It draws the conclusion that volatility in international financial markets is currently perhaps one of the most harmful factors for enterprises and labour in developing countries, particularly in the middle-income countries that have been most prone to financial turmoil. Hence, the paper suggests how greater policy coherence between international and national economic and employment policies can give greater attention to employment and incomes.

**Graph 1: FDI and Investment as Share of GDP, World (1970-2004)**



Source: World Bank, WDI, online database, as of May 2006.

**Graph 2: World GDP Growth, 1961-2004**



Source: World Bank, WDI 2003 and 2005 on CD-Rom.

In discussing the rules, conditions and behaviour at international financial markets, different authors use different terms to describe recent developments. In this paper, the following terms are employed: Financial openness<sup>6</sup> is used as an umbrella term that includes both financial integration and financial liberalization. Financial liberalization in turn incorporates the liberalization of the capital and financial account<sup>7</sup>, but also other elements such as less or different supervision and regulation of the banking sector and often a liberalization of the foreign exchange rate regime. The difference between financial integration and financial liberalization is that the former describes a situation in which a country is more integrated in the world financial markets (i.e. through higher FDI/GDP ratio), while financial liberalization means changes in laws and regulations, which may (or may not) lead to greater financial integration.<sup>8</sup>

<sup>5</sup> The latter is discussed in a recent ILO paper by Ajit Ghose (2004) and in two recent documents prepared for the ILO’s governing Body (ILO 2002 and 2004b). Ghose concludes that the “available empirical evidence in fact suggests that capital account liberalisation is neither necessary nor sufficient for inducing FDI inflows.” (Ghose 2004: 23f.).

<sup>6</sup> Prasad et al. (2004) use another term, namely financial globalization; this is close to what others and this paper call financial openness.

<sup>7</sup> Congruent with the literature, we henceforth use “capital account liberalization” as shorthand for the liberalization of the capital and financial account (while acknowledging that, strictly speaking, the relaxation of rules that refer to direct investment and portfolio flows should be called “financial account liberalization”; for the standard presentation of the Balance of Payments see IMF, 2004).

<sup>8</sup> It should be noted that some countries have become more financially integrated, without or with little financial liberalization (e.g. China), while other countries have financially liberalized but have not become more financially integrated – either because of geopolitical circumstances, or because

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Since this paper focuses on private capital flows (i.e. those private international transactions that are recorded under the balance of payments' financial account), it will only make reference in passing to other important sources of foreign financing – such as official and private development assistance, income generated from exports and workers' remittances. Although the latter are a genuinely private form of financial flows, they do not establish an investment position and are, therefore, recorded under the current account.<sup>9</sup> Using a broad definition, the World Bank estimates that remittances to developing countries amounted to 166.9 billion US\$ in 2005, compared to 85.6 billion US\$ in 2000 and 31.2 billion US\$ in 1990 (World Bank 2005a: 88). Remittances are not only a rapidly growing source of external finance, but they are generally continuous over the years and not prone to sudden reversals of direction (Ratha 2005). Moreover, they even tend to be countercyclical (i.e. migrants send more money home to support their families at times of crises) and hence help to smoothen consumption volatility. Although very large remittance flows can cause “Dutch disease” problems, their overall economic impact is generally thought to be positive (World Bank 2005a: chapters 4 and 5; Giuliano and Ruiz-Arraz 2005). In particular, remittances can make a significant contribution to poverty reduction since they often directly benefit poorer households (Adams and Page 2005).

The remainder of the paper is organized as follows: We first discuss the effects of financial openness on labour (Section 2.) by looking into the effects that are moderated through a possible growth effect (Section 2.a), by discussion financial volatility and crises (Section 2.b), by providing some evidence on the direct effects of financial crises on employment (Section 2.c), and finally by examining the effects of crises on wage shares in national income (Section 2.d). A short summary of the main findings follows in Section 2.e. Some policy responses that could make the international financial system more conducive to the goal of productive employment and decent work are outlined in Section 3. by drawing on the report of the World Commission on the Social Dimension of Globalization. Policies in industrialized countries, new rules for the international system and policies in developing countries are in turn addressed before the paper attends to the role of institutions in designing and implementing coherent policies.

## **2. Financial Openness and Labour**

How does financial openness affect labour? In this section, we follow several lines of argument.

First, we briefly review the effects of liberalization on growth. Here, two arguments are advanced: In addition to the potential direct positive effect of capital flows on growth (as countries gain additional resources that can be invested), there can also be an indirect negative effect on growth. In particular, financial liberalization forces countries to hold a larger amount of foreign reserves which reduces incomes and growth potential. If financial flows have, on balance, a positive impact on growth, this would be generally beneficial for labour, while slow growth is usually disadvantageous for labour. However, even in the case of fast or steady growth, the distributional impact on different categories of labour needs to be taken into account. Labour might be benefiting less than appropriate and necessary for long term institutional and human capital development.

they have been ignored by the international financial markets (various African countries would fall into this category). See the discussion in section 2.a.

<sup>9</sup> Hence, the statistics presented e.g. in Annex Table 1 and 3 exclude workers' remittances. See the classification in IMF (1993) and the technical discussion in World Bank (2005a: 105ff.)

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Secondly, we look into the effects of international financial flows on volatility, and their role in provoking financial crises. If financial crises become more frequent, their negative consequences for growth (both in the short and long run) could cancel out any benefits from financial liberalization, or even lead to a net negative effect of financial openness on growth. Moreover, financial crises can have impacts on labour that go over and above their general economic impact. Since, as indicted above, volatility and the frequency of financial crises have increased, we review their direct impact on employment. This is followed by a discussion of wage shares, and how they have evolved during crises, and a summary of the main findings.

## 2.a Financial Openness and Growth

### Direct effects on growth

A recent study by IMF researches (Prasad et al. 2004) has confirmed the main findings of earlier studies such as those undertaken in UNCTAD (2001): it is difficult to establish a robust causal relationship between financial integration and growth. In general, growth is more depending on the quality of domestic institutions and careful macro-economic management. Edison et al. (2004) argue in the same direction and demonstrate that the findings of previous research (that found a positive association between capital account openness and growth) crucially depended on the country coverage, the choice of time periods and the indicator for capital account openness. They also find evidence for a suggestion that was first made by Rodrik (1998), namely that conventional indicators for capital account openness closely proxy the reputation of a country's government. If governance is controlled for, capital account openness has no significant effect on economic performance (Edison et al. 2004: 243ff.). By contrast, Tornell et al. (2003) study a sub-set of countries with functioning financial markets (thus excluding the majority of developing countries) and argue that switching to a regime of *de facto* financial openness will ease credit constraints, which leads to higher growth but also increased risk of financial crises. By their account, the growth effect outweighs the cost of crises. This result runs counter to the findings presented by Lee and Jayadev (2005) who use a *de jure* measure of capital account liberalization (rather than a *de facto* measure that reflects the success in attracting inflows). For the period from 1973-1995 (i.e. even when excluding the negative impact of the East Asian crisis), they find no positive effect on growth rates and, contrary to theory, some indication that openness reduces the investment share in GDP.

The conflicting results could in part be caused by differences in country coverage, but also by differences between the indicators employed in the literature. Prasad et al. (2004) and Collins (2005) highlight the crucial difference between "de jure" or "de facto" measures of financial openness. "De jure" financial openness (or financial liberalization) includes abolishment or changes in rules and regulations concerning foreign capital, as it is often required as part of the conditionality for financial support by the International Financial Institutions. Many countries in Latin America fall under this category. By contrast, "de facto" financial openness (or financial integration) relates to increases in a financial openness indicator, irrespective of whether rules have changed or not (India and China, but also other Asian countries fall into this category.) In the latter case, the causal relationship between financial openness and growth is more difficult to establish. Did financial integration lead to higher growth or did higher growth induce financial integration? Rodrik (2003) and Singh (2003) argue that especially for India and China, growth induced greater financial integration. Policy discussions should therefore emphasize firstly appropriate growth strategies, and, in the light of those, consider various variants of liberalization. Tokman (2003) for example argues that slow growth cum liberalization in Latin America has led to a greater informalization of the work force, persistent poverty and greater inequality.

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Another factor to explain the difference in results could be the different impact of financial openness across countries. As Edison et al. (2004) argue, capital account liberalization can be beneficial to middle-income countries under certain conditions, while low-income countries with a poor regulatory framework and inadequate institutions have little to gain. The importance of institutions and the policy framework as a pre-condition for capital account liberalizations is also pointed out by Gilbert et al. (2001). They conclude that “[b]y itself, capital account liberalisation will deliver relatively little” while leaving poor countries more vulnerable to crisis (ibid.: 121). An even more pessimistic view emerges from the study by Lee and Jayadev (2005) who find that even when the most commonly mentioned pre-conditions are met, capital account liberalization has, overall, no positive effect on growth.

While the argument that the impact of financial flows depends on country characteristics is most frequently applied to portfolio equity and short-term debt flows, it has also been made for FDI. Ghose (2004) found that the effects of FDI on the host country crucially depended on country specific circumstances, in particular whether they met an unmet demand for investment finance (e.g. to build up export-oriented manufacturing industry). However, FDI does not always add to the productive capacity of the recipient country, but can also crowd out domestic investment when foreign entrepreneurs seize upon investment opportunities that would have otherwise been taken up by domestic enterprises (Ghose 2004). A similar point is made by Hanson in a paper for the G24 technical secretariat; he argues that “[t]here is weak evidence that FDI generates positive spillovers for host economies” (Hanson 2001: 23). The overall effects of FDI on employment are mixed, as an ILO Governing Body paper suggests:

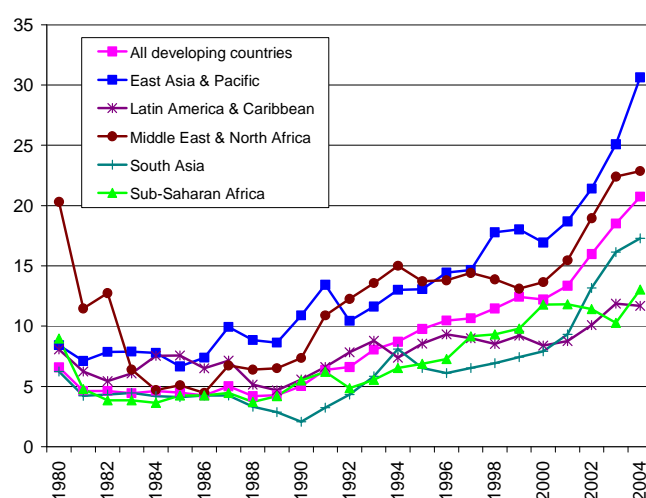
“When viewed together, the findings from empirical research show that employment effects of FDI inflows to developing countries are rather weak and are not unambiguously positive or negative. Such inflows at best make a weak contribution to increasing the rate of investment in recipient countries. At the same time, a rising share of FDI in total investment tends to reduce the overall employment elasticity while shifting the pattern of labour demand in favour of high-skilled labour. Rising wage inequality is also a consequence. On the positive side, a rising share of FDI in total investment leads to an improvement in the average quality of employment for both high-skilled and low-skilled labour.” (ILO 2004b: p. 10, para. 35)

### Indirect growth effects through increased reserve holdings

As a consequence of financial openness and of the instability of the current international financial system, developing countries have been increasingly building up foreign reserves since the early 1990s. For some countries these reserves were created by surplus on the current account, while others built up reserves through capital inflows which were not spent on foreign goods. As Feldstein (1999) argues, increasing international liquidity is an effective ‘self help’-strategy in the absence of an international lender of last resort. However, while giving countries some protection against financial crises, holding large international reserves is also a costly strategy as foreign reserves are held in low interest bearing instruments such as US treasury bills, rather than earning much higher returns on the capital market or through investment into human or physical capital. Baker and Walentin (2001) estimate that the increased reserve level of the late 1990s compared to that common in the 1960s implies an annual cost of around 1 per cent of GDP in most regions, and of between 1.2 and 2.5 per cent in East Asia and the Pacific. They argue that the gains of trade liberalization in terms of higher GDP growth were actually “eaten up” for most countries in the 1990s by the earning forgone on holding higher reserves (ibid.). In a more recent study, Rodrik (2006) estimates that the cost of increased reserve holdings is 1 per cent of GDP on average for developing countries. While imposing costs on developing countries, increased reserve holdings are indirect subsidy to the countries in whose currency the reserves are held (see Stiglitz 2000).

What is striking, however, is that the trend of the 1990s has accelerated in the first years of the current century to a somewhat alarming level (see Graph 3). Overall, reserves held by low- and middle-income countries were equal to 20.7 per cent of their GNI in 2004, compared to 6.9 per cent in the first half of the 1990s – a threefold increase.<sup>10</sup> The substantial increase took place in low- and in middle-income developing countries alike, and across regions. Even a poor region like sub-Saharan Africa now holds foreign reserves equal to 13.0 per cent of its GNI, more than double compared to the first half of the 1990s. The trend is particularly strong in South Asia and in East Asia and the Pacific. In the latter region, the growth of reserves is only in part driven by China (the developing country with the largest foreign reserves). Even when China is excluded, there remains a substantial increase from an already high 15.1 per cent of GNI (1990-94) to 26.0 per cent in 2004 for the rest of the region (see Annex Table 4).

**Graph 3: Reserve Holdings by Developing Countries, 1970-2004 (in % of GNI)**



Source: World Bank, *Global Development Finance 2005*, online database (Washington, DC, as of May 2006); based on series 'International Reserves (US\$)' and 'Gross National Income (US\$)'.

Part of the explanation for the accelerated build-up of international reserves is that developing countries, particularly those from Asia, accumulated reserves after the financial crises of the late 1990s in order not to be obliged to request support from international financial institutions in times of future crises (see Bird and Mandilaras 2005). In a recent cross-country study, Aizenman and Lee (2006) find that changed risk perception after the Mexican and the East Asian crises (as proxied by dummy variables) and the degree of capital account openness are indeed the main factors behind the surge in reserve levels. By contrast, variables linked to export promotion regimes, such as a depreciated real exchange rate and high lagged export growth rates, had only a small (yet statistically significant) impact on reserve levels. The results also confirm that China is not an outlier with respect to the level of its international reserves (*ibid.*: 3). This refutes arguments that attribute China's reserve levels to the country's exchange rate policies (see e.g. Dooley et al. 2003; Goldstein 2003). As Prasad and Wei (2005) demonstrate, the recent steep rise in China's foreign reserves is mostly due to large non-FDI capital inflows, and not to the current account surplus or FDI.

<sup>10</sup> By contrast, foreign reserves have remained at under 5 per cent of GDP in industrialized countries (Rodrik 2006: 15).

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## 2.b Financial Openness, Volatility and Crises

Prasad et al. (2004) made also another pertinent observation, namely that financial liberalization in developing countries is associated with higher consumption volatility and increased GDP volatility than in developed countries. This observation is consistent with those of many other researchers (see e.g. Kose et al. 2003; Levchenko 2005), and especially with those who emphasize the need for stronger institutions as a precondition for development. Kaminsky et al. (2004) pointed out that the absence of sound financial regulation, both at the national and international levels, makes developing countries much more vulnerable to negative impacts of capital flows. When institutions with the ability to manage greater volatility are absent or not fully effective, the generally procyclical nature of international capital flows (“when it rains it pours”-syndrome) adds to the effects of fiscal policies, and, to a certain extent, also macroeconomic policies, that tend to be procyclical in most developing countries. Such procyclical behaviour deepens and prolongs a crisis.

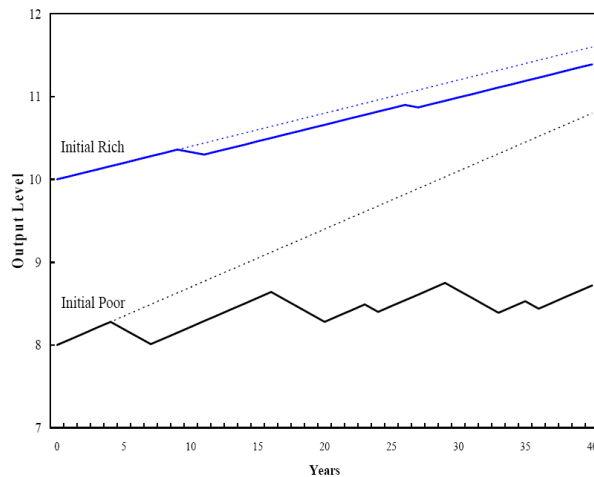
Other research confirms that developing countries have indeed become more prone to both currency and banking crises after financial liberalization (see e.g. Weller 2001; Tornell et al. 2003). Countries from across East Asia and Latin America have suffered from such crises during the 1990s and thereafter, with the Argentinean crisis of 2000/01 being a particularly bold example. Other countries, such as Russia and Turkey, have also been severely affected.<sup>11</sup> When crises break out, they often cannot primarily be explained by any deterioration in a country’s so-called ‘fundamentals’. Rather, they can occur as a result of volatility in international capital markets that leads to changes in risk perceptions and risk averseness of investors and creditors. Second generation models of financial crises have investigated this channel of contagion in great detail, and argued that a crisis can spread from one country to another even when there are few economic linkages between them (Kaminsky and Reinhart 2000; van Rijckeghem and Weder 2001; Caramazza et al. 2004; Goldstein and Pauzner 2004).

Financial crises typically have a large impact on the real economy. In the five countries most affected by the East Asian crisis of 1997/98, GDP per capita fell between 2.8 per cent (Philippines) and 14.8 per cent (Indonesia). In Latin America, the Mexican crisis of 1994/95 led to a decline in incomes by 7.8 per cent, and the Argentinean crisis of 2001/02 reduced the country’s per capita incomes by 16.3 per cent.<sup>12</sup> A recent study by Hutchinson and Noy (2005) documents that so-called “sudden stop” crises (a reversal in capital flows and a simultaneous currency crisis) have a particular harmful effect on output – over and above that of ‘normal’ currency crises. On average, they cause a cumulative output loss of 13 to 15 per cent of GDP over a three-year period. One important factor behind this trajectory is often the disarray financial crises cause in the banking sector. Burdened with non-performing loans, the domestic banks fail to perform their function of providing credit at a time when it is most needed. An extreme case of a prolonged credit crunch is Mexico, where real credit continued falling until 2002 – eight years after the crisis of 1994 (see Tornell et al. 2003: 54ff.).

<sup>11</sup> For a comprehensive overview see Caprio and Klingebiel (2003).

<sup>12</sup> See World Bank (2005a); based on series “GDP per capita (constant 2000 US\$)”.

**Graph 4: Typical Growth Path after a Financial Crisis in Rich and Poor Countries**



Source: Cerra and Saxena (2005: 24)

Financial crises can therefore have long-term implications, although there is some controversy about how big and permanent the costs of financial crises are. Tornell et al. (2003: 23) argue that crises “are the price that has to be paid in order to attain faster growth”, and that that it is possible for GDP growth to recover rapidly from a crisis (although this need not happen and actually did not happen in Mexico, the case they study in more detail). The view that crises pose only a temporary set-back is challenged by Cerra and Saxena (2005), who deconstruct what they call the ‘myth of recovery’ by using panel data for broad datasets of countries. They document that recessions are typically not followed by high-growth recovery phases, either immediately following the trough, over several years of the subsequent expansion, or even over the complete subsequent expansion that follows a complete recession (see Graph 4). Indeed, for most countries, growth is significantly lower in the recovery phase than in an average expansion year. Thus, when output drops, it tends to remain well below its previous trend. As they argue,

“political and financial crises are costly at all horizons. Financial crises contribute to half of the episodes of negative growth, and there is no evidence that they typically lead to economic reforms or policy adjustments that restore output to trend. Change to a more democratic government system, on the other hand, improves the rebound from a recession. We also find evidence that while trade liberalization increases the long-run growth rate, it can weaken recovery from recession. However, such weak recoveries tend to occur in combination with liberalized capital account regimes.” (Cerra and Saxena 2005: 24)

Another important point the authors make is that frequent crises and instabilities prevent a smooth convergence process as the neoclassical growth literature indicates:

“When shocks derail growth, incomes [between countries] diverge. Poor countries have respectable expansion, and therefore do not appear to be stuck in a poverty trap. However, many poor countries do appear to be mired in a crisis trap. Countries that experience many negative shocks to output tend to get left behind and their long-term growth suffers. Thus, while standard growth theory may work well in explaining expansion, a fruitful direction for future research would be to explain the proclivity to wars, crises, and other negative shocks.” (Cerra and Saxena 2005: 24)

This is related to the point Rodrik (2003) makes, namely that policies for stimulating growth are different from policies to sustain growth and that frequent crises require frequent policy regime switches.

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## 2.c Financial Openness, Crises and Employment

Financial crises are generally not only associated with an economic decline, but also with severe social costs. These are most prominently felt in terms of rising open unemployment, falling employment-to-population ratios, falling real wages, or a combination of the above (see e.g. Lee 1998). Moreover, the social costs can usually be felt longer than the economic impact: Even when GDP per capita has recovered to pre-crisis level, the other indicators usually lack behind (see World Commission on the Social Dimension of Globalization 2004: 40f.). This pattern can be observed in a majority of countries that were most affected by the financial crises of the past decade. Mapping the observed trends against a counterfactual with limited financial openness and no financial crises would, from an analytical perspective, of course be the empirical strategy of choice. However, such a counterfactual is excessively difficult to construct. Taking countries with a lower *de facto* openness, e.g. in sub-Saharan Africa, as a reference point would also be imprudent since initial conditions in the region differ systematically from those in East Asia or Latin America (be it with respect to human capital endowments, institutional capacity or industrial diversification). The following paragraphs therefore compare the situation before to that after a financial crisis and provide some of the most salient examples.

### Impact of financial crises on employment in Latin America and Turkey

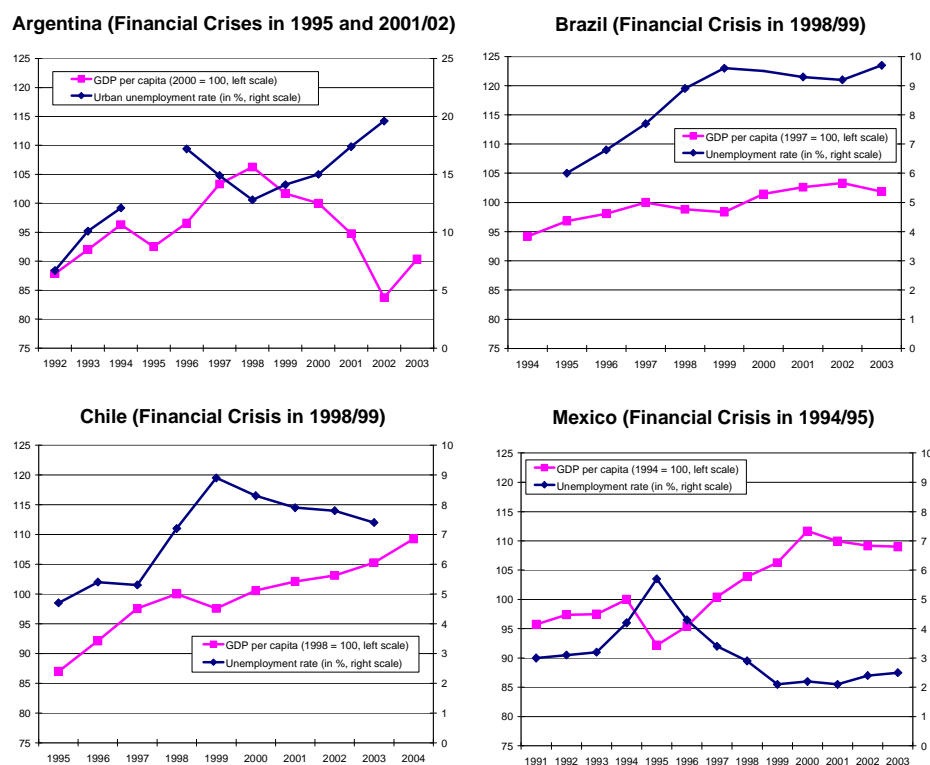
Latin American countries experienced several periods of financial turbulence since the early 1990s. The most prominent examples are the Mexican “Tequila crisis” during 1994/95 and the currency crisis in several South American countries in the aftermath of the East Asian and Russian crises. One of the crisis-hit countries was Brazil, which has experienced large foreign capital inflows from 1994 onwards, when the Real Plan had introduced a new stable currency (see Cinquetti 2000). To prevent an over-appreciation of the Real, inflows were temporarily taxed, but these taxes were gradually phased out and inflows continued at high levels. When the investor sentiment swung suddenly after the Russian debt default of August 1998, Brazil responded by tightening its monetary policy in an effort to defend the exchange rate. Even though interest rates reached 40 per cent in late 1998, the capital flows out of Brazil were massive and depleted the country’s reserves by 30 billion US\$ within 50 days (see Averbud 2002: 930f.). When outflows reached 1 billion US\$ per day in January 1999, the Central Bank allowed the Real to devalue massively over the following weeks (ibid.). The currency crisis, in combination with the recessionary impact of high real interest rates, led to a relatively modest decline of per capita incomes that nonetheless was accompanied by an increase in unemployment from 7.8 per cent in 1997 to 9.6 per cent in 1999 (see Graph 5). Despite the subsequent economic recovery, unemployment rates have not recovered and remained close to ten per cent in 2003.

Like other emerging economies, Chile received large international capital inflows in the beginning of the 1990s. But unlike most other countries, Chile reacted by imposing controls on capital inflows in the form of an unremunerated reserve requirement (URR).<sup>13</sup> Although it is uncertain whether this augmented the overall amount of inflows, research shows that it reduced speculative capital inflows: the share of short-term debt in total external debt fell from an already low level of 19.4 per cent in 1990 to 4.8 per cent in 1997 – at a time when other countries increasingly relied on short-term financing (de Gregorio et al. 2000: 70f.). At the onset of the Asian crisis, Chile was thus considerably less exposed to international volatility. Also, the peso was at the lower (appreciated) end of the exchange

<sup>13</sup> The URR was introduced in June 1991 and in place until June 1998. It acted like a tax on inflows and allowed for a differential between world interest rates and those in Chile, while keeping inflows under control (see de Gregorio et al. 2000).

rate band at the time, leaving room for a relatively large devaluation within the band. However, the Central Bank feared that a depreciation could endanger the inflation target. Therefore, it defended the peso against growing pressure with a mix of monetary tightening and interventions on the foreign exchange market, before finally allowing the peso to float in September 1999 (Morandé and Tapia 2002: 5).

**Graph 5: Medium-Term Effects of Financial Crises on Unemployment in Latin American Countries**



Source: World Bank, World Development Indicators 2005, series "GDP per capita (constant 2000 USD)"; International Labour Office, Key Indicators of the Labour Market, 4th edition.

Solimano and Larraín (2002: 17f.) argue that the Central Bank effectively prioritized "[l]ower inflation over higher growth and employment" (ibid.). The high interest rates had indeed recessionary impact, and unemployment increased from 5.3 per cent in 1997 to 8.9 per cent in 1999. While GDP per capita regained its 1998 level in 2000, unemployment had only modestly recovered by 2003 (when it still stood at 7.4 per cent). Solimano and Larraín (2002) discuss several hypotheses that could explain the sluggish employment performance, among them firm-restructuring, continued job losses in small and medium enterprises (SMEs) and the noticeably slower rate of GDP growth after the crisis. They warn that unemployment could become a structural problem in Chile unless capital formation accelerates (ibid.: 28f.).

Following the liberalization in Mexico, financial inflows expanded rapidly in the early 1990s, but dried up and eventually reversed in 1994. Gunther et al. (1996) argue that these flows were the major determinant of Mexico's reserve position and exchange rate. The peso devaluation of December 1994 (see Ibarra 1999) brought the recently privatized, already fragile banking system into considerable difficulty as the peso value of foreign denominated debt changed overnight. Similarly, the balance sheet positions of companies which had accumulated debt in US dollars deteriorated rapidly (see Carstens and Schwartz 1998; Mishkin 1999), which in turn led to a sharp fall in investment by the affected companies (Aguar 2005). Taken together, this can explain how a currency crisis rapidly turned into a crisis of the real economy and provoked a recession with an eight percent drop in per capita income in 1995. Unemployment, that had been relatively stable at around three per

cent before the crisis, started to increase during 1994 and averaged 5.8 per cent in 1995, almost twice the pre-crisis rate. However, these figures still mask the loss of jobs in the formal sector since the share of informal employment rose from 30 percent in 1993 to 35 per cent in 1995 (KILM, 4th edition). The economic recovery was relatively fast, and by 1997 Mexico had achieved its pre-crisis income level. Unemployment was still above pre-crisis level, but fell to 2.9 per cent in 1998, lagging the economic recovery by only one year. However, at 32 per cent, the share of informal employment was still above the pre-crisis level that year.

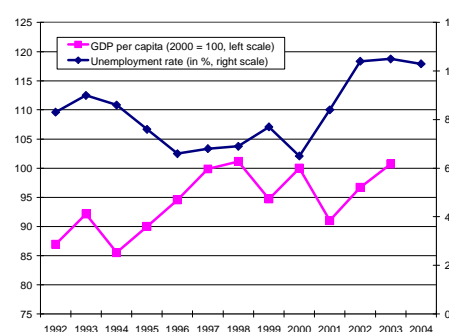
The case of Argentina stands out for the country went through two financial crises, in 1995 (when investors withdrew capital following the Tequila crisis in Mexico) and again in 2001/02, leading to the collapse of the currency board (see Daseking et al. 2004). The first crisis only caused relatively mild downturn, and, with considerable foreign support, pre-crisis income levels were again reached in 1996 (see Damill et al. 2002: 9ff.). As in other countries, the unemployment rate (that covers only urban areas in the case of Argentina) was still far above the pre-crisis level at this point, but it was approaching its 1994 level by 1998. The recession that set in that year meant, however, that unemployment increased again and never fully recovered to its pre-crisis level. Argentina therefore went into the 2001/02 crisis with an already high level of (urban) unemployment (15 per cent in 2000), that rose to almost 20 per cent by 2002.<sup>14</sup> Economic turbulence and the cumulative effects of two financial crises have thus caused a substantial unemployment problem in a country where unemployment rates had fluctuated around five per cent for most of the 1980s (KILM, 4th ed.).

In Turkey, the frequency of crises was even higher than in Argentina. The country had liberalized its economy throughout the 1980s, but embarked on full capital account liberalization only in August 1989. Since, capital flows have been highly volatile and have contributed to the repeated crises that affected the country in 1994, 1998/99 and 2001. As Demir (2004) argues, the country went into a vicious cycle of crises, where the loss in output reduced public revenues and increased public borrowing through short-term treasury bills that were bought by domestic banks, which re-financed themselves through short-term loans from abroad – building up currency risks and setting the stage for the next crisis.

Further, the resulting high real interest rates reduced investment and prospects for long-term growth (see also Akyüz and Boratav 2003). Whereas recovery from the first crisis in 1994 was relatively smooth – both in terms of GDP and employment –, the second and especially the third crisis proved to be more severe. Their combined effect meant that per capita incomes were still at their 1997/98 level in 2003 (see Graph 6). Unemployment peaked briefly during 1999 and was back at its previous level of around 6.6 per cent in 2000, before the next crisis set in. The third crisis led to a dramatic rise in unemployment: it reached 10.6 per cent in 2002, at a time when incomes had almost recovered to their pre-

**Graph 6: Medium-Term Effects of the Turkish Financial Crises on Unemployment**

Turkey (Fin. Crises in 1994, 1998-99 and 2001)



Source: World Bank, World Development Indicators 2005, series "GDP per capita (constant 2000 USD)"; International Labour Office, KILM, 4th edition.

<sup>14</sup> Unfortunately, the methodology of the Argentina's Permanent Household Survey changed significantly in 2003 so that the unemployment rate of 15.6 per cent that is given in KILM 4th edition is not directly comparable to the previous data.

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crisis level, and remained in excess of ten per cent in 2003 and 2004. The pattern that employment recovery lags economic recovery is thus found in the last crisis, but not in the earlier, somewhat milder crises.

### The employment impact of the East Asian crisis

That financial crises typically translate into crises of the real economy is also clearly evident from the experience of East Asia. Here, both output and capacity utilization fell sharply during the 1997/98 crisis. In a survey of firms in Korea, Thailand, Indonesia and Malaysia, entrepreneurs list the drop in domestic demand, rising costs for imported inputs, and the high interest rates as the most important reasons (see Dwor-Frécaut et al. 2000: Ch. 1). The declining capacity utilization had adverse impacts on the average profitability and liquidity of firms, and many companies abandoned or scaled down planned investments (*ibid.*: *passim*). Interest rate and currency shocks also forced many companies into bankruptcy as they found themselves unable to service their debt, much of which was in foreign currency (Kawai et al. 2000: 77ff.). Data from five countries worst affected by the East Asian crisis show that also many of the surviving firms reduced their workforce in 1998, while only a small fraction hired more staff (see Dwor-Frécaut et al. 2000: 4f.). Accordingly, unemployment increased throughout the region, and incomes fell – in some cases dramatically, pushing people below the poverty line. According to ILO estimates, the number of working poor in South East Asia (using the threshold of 1 US\$ per day) rose from its pre-crisis level of 33.7 million in 1996 to 50.6 million at the height of the financial crisis in 1998 – an increase of almost 17 million (see Kapsos 2004: 14f.).

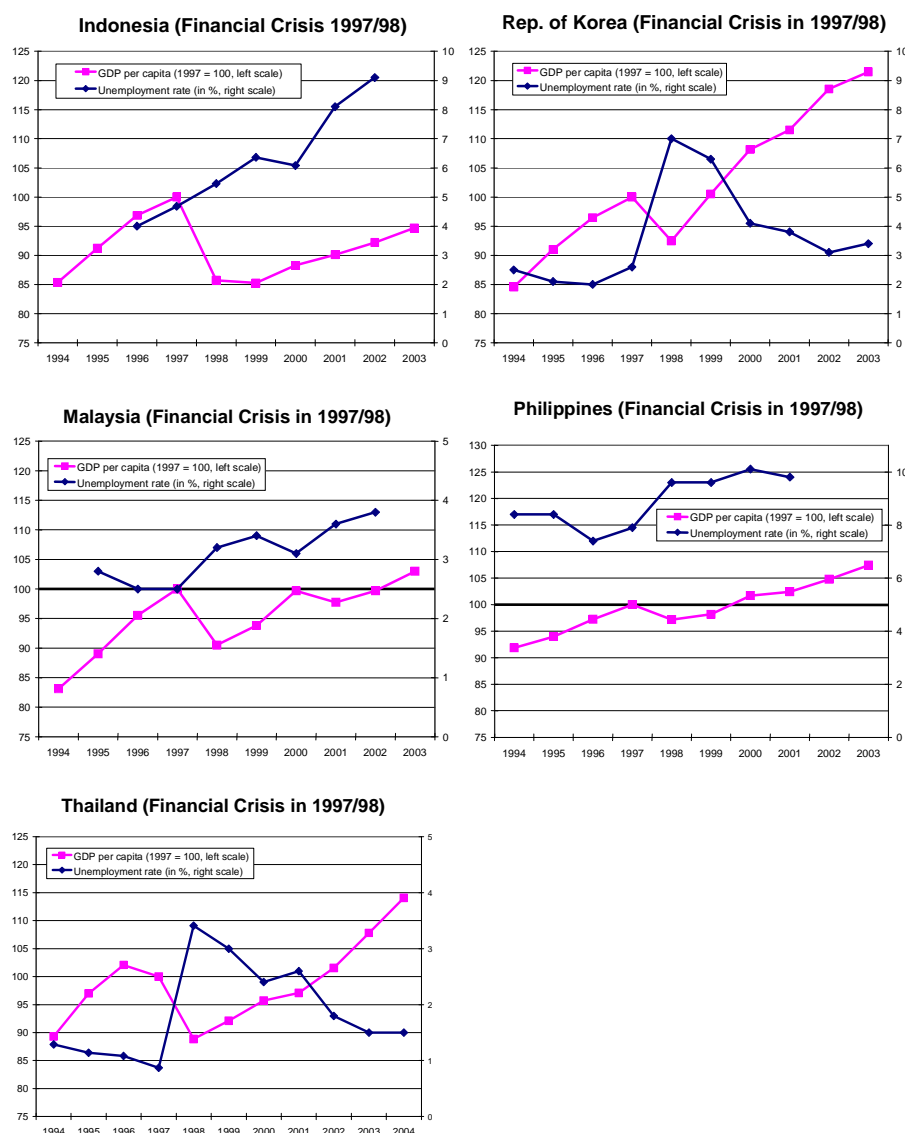
A more detailed look at the country level shows that, at the beginning of the East Asian financial crisis in 1997, Thailand, Korea and Malaysia had virtually achieved full employment with unemployment rates of close to 1.0 per cent (Thailand) or 2.5 per cent (Korea and Malaysia) (see Graph 7). By 1998, the combination of production cut-backs and layoffs through bankruptcies had brought unemployment to 3.4 per cent in Thailand, or 1.1 million (up from 0.3 million). In addition, about 0.2 million workers left the labour force despite strong growth of the working age population (KILM, 4th edition). Many workers had to find a new source of income in the informal economy which grew significantly during the crisis. This development is mirrored by a rise in the number of self-employed by 0.8 million. Hidden unemployment in the form of underemployment also increased almost two-fold (from 2.3 million to 4.4 million). A further effect of the crisis was a decline in real wages by 4 per cent within a year (see Mahmood and Aryah 2001: 266ff.)<sup>15</sup>.

In Korea, thirteen large conglomerates became insolvent during 1997. Delays in payments by the large corporations dragged many small and medium enterprises (SMEs) into the crisis; 8,200 of them failed in 1997 and a further 10,500 in 1998 (see Kawai et al. 2000: 77ff). The Korean labour market suffered severely from the wave of redundancies that accompanied these bankruptcies, and the reduction in the work force of surviving companies. Open unemployment rose to 7 per cent or 1.5 million (up from 0.6 million), a level not seen in decades. Among the hardest-hit groups were manual production workers and those in clerical grades. By the first quarter of 1999, total employment had fallen to 19 million, down by 2.1 million from the fourth quarter of 1997 (see Kang et al. 2001: 98f.). The disparity between the growth in unemployment and the far larger decline in employment can be attributed to the fact that around 350,000 workers (in particular women) left the labour force altogether, resulting in a decline of the labour force participation rate by almost two percentage points (KILM, 4th edition). The increase in unemployment was less dramatic in Malaysia, where the rate rose by less than a percentage point. Nonetheless, around 250,000

<sup>15</sup> Women in urban areas suffered a disproportionate wage loss (-10.5 per cent), and workers in manufacturing (-13 per cent) and construction (-24 per cent) were also badly affected (Mahmood and Aryah 2001: 267).

formal sector jobs were lost in 1998 (see Jomo 2001: 34 and Table 26). Many of the retrenched workers were foreign migrant workers, which cushioned the effect on the domestic labour market (see Mansor et al. 2001: 144f.). ILO data also show that agricultural employment expanded by 135,000 in 1998. The absorption of labour by the primary sector helped to contain the rise in open unemployment, but contributed to falling labour productivity in agriculture (KILM, 4th edition, and WDI 2005).

**Graph 7: Medium-Term Effects of the East Asian Financial Crises on Unemployment**



Source: World Bank, World Development Indicators 2005, series "GDP per capita (constant 2000 USD)"; International Labour Office, Key Indicators of the Labour Market, 4th edition.

Indonesia (4.7 per cent unemployment in 1997) and the Philippines (7.9 per cent) went into the financial crisis with considerably higher unemployment, but their situation worsened further. In Indonesia, about 2.5 million workers lost their jobs in 1997/1998, 1 million in manufacturing alone (see Islam et al. 2001: 50ff.). The fall in industry and services employment was offset by an expansion of agriculture employment, so that open unemployment grew only modestly during 1998 (+0.8 percentage points) despite strong labour force growth. However, unemployment continued to rise in subsequent years and reached 9.1 per cent in 2002, the most recent year for which data are available. Real earnings also fell by about 40 per cent during the crisis and were still about 10 per cent below their pre-crisis level in 2000 (Dhanani and Islam 2004: 29f.). In the Philippines, where the crisis only had

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a comparatively mild economic impact, unemployment rose to 9.6 per cent in 1998 (+1.7 percentage points). It has since remained at levels close to 10 per cent.

The East Asian experience, too, shows that progress in returning to pre-crisis unemployment is generally far slower than the pace of economic recovery.<sup>16</sup> Korea, Malaysia and the Philippines had all reached their pre-crisis per capita GDP in 1999 or 2000, but unemployment remained above pre-crisis level at that point in time. In Korea, the country with the strongest post-crisis output growth, unemployment rates were close to their pre-crisis level only in 2002 (lagging the economic recovery by three years). One factor behind this relative success is the active policy response by the Korean government that invested considerable resources (about 2.2 per cent of GDP in 1998) to assist the unemployed, to create new jobs, and to expand public employment services (see Kang et al. 2001: 109ff.). However, progress has not been sustained in 2003, when unemployment rose marginally. By contrast, there is still no sign of return to pre-crisis unemployment rates in either Malaysia or the Philippines. This makes the prospect of a return to pre-crisis unemployment levels seem uncertain – despite economic consolidation. In Thailand, the economic recovery was completed in 2002. At 1.8 per cent, unemployment has been reduced to about half of its peak in 1998 (although this is still twice the pre-crisis level). The picture is most devastating for Indonesia, where per capita incomes are still below their 1997 level and the unemployment rate continues to rise. It stood at 9.1 per cent in 2002, also roughly twice its pre-crisis level.

## **2.d Financial Openness, Financial Crises and Labour Shares**

Contrary to the conventional wisdom that sees the labour share in GDP as constant, research by Diwan (2001) and Harrison (2002) shows that the proportion of GDP that goes into wages and other labour income is variable over time. Using a data set from 1960 to 1997, Harrison (2002) splits her sample of over 100 countries into two even groups (based on GDP per capita in 1985). Her data show that, in the group of poorer countries, labour's share in national income fell on average by 0.1 percentage points per year prior to 1993. The decline in the labour share was more rapid after 1993, when it started to fall by an average by 0.3 percentage points per year. In the richer sub-group, the labour share grew by 0.2 percentage points prior to 1993, but then fell by 0.4 percentage points per year. These means indicate a trend reversal for the richer countries post-1993, and an acceleration of an already downward trend for the poorer sub-group.

After establishing a declining trend of the labour share for many countries, Harrison (2002) tested for factors that can explain changes in labour shares, combining detailed national accounts data from the United Nations with measures of trade openness, capital account restrictions and capital flows. Overall, the results suggest that changes in factor shares are primarily linked to changes in capital/labour ratios. However, measures of globalization (such as capital controls or direct investment flows) also play a role. Harrison found that exchange rate crises lead to declining labour shares, suggesting that labour pays a disproportionately high price when there are large swings in exchange rates (i.e., wages are

<sup>16</sup> The negative impact of financial crises on employment indicators can also be observed in Russia in the aftermath of the Rouble collapse of August 1998 and in industrialized countries like Sweden and Finland, which were both affected by banking crises during the early 1990s. In the case of Finland, the collapse of the Russian export market was another significant factor behind the economic downturn, but all three cases showed a higher level of unemployment even after the crises has been over and the economy had recovered to its pre-crisis income levels (documentation available upon request).

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more severely affected than GDP).<sup>17</sup> Capital controls are associated with an increase in the labour share, an effect that Harrison (*ibid.*: 20) attributes to the stronger bargaining position of capital vis-à-vis labour since the cost of relocating production increases with capital controls.<sup>18</sup> In addition, increasing trade is associated with a fall in the labour share. This result is robust across specifications. Other factors, such as government spending, also matter. Increasing government spending is associated with an increase in labour shares, for both rich and poor countries. Finally, foreign investment inflows are associated with a fall in the labour share (*ibid.*). These results point to a systematic negative relationship between various measures of globalization and the labour share.

The overall decline in the labour share is partly explained by what some call the ratchet effect: After an economic shock or a financial crisis, it has been a well-established fact that the labour share in gross national income decreases (van der Hoeven and Saget 2004: 201). In the 1980s some authors argued that the decline in labour share after the economic shocks was, in effect, the consequence of a too high labour share before the crisis in the 1980s and thus partly blaming labour for the build-up of the crisis. However, only in a minority of cases have financial crises been caused by bidding up wages and labour shares. In most cases the crisis was caused by external events or rent-seeking behaviour of capital owners. In a study of the manufacturing sector, Amsden and van der Hoeven (1996) therefore conclude that “forcing firms to restructure under the highly contractionary (and destabilising) conditions [of the 1980s] stymies rather than stimulates change”. And based upon a large sample of developing countries, they argue that “[g]iven what appears to have been an absence of thorough going industrial restructuring in most non-Asian developing countries in the 1980s, the decade’s decline in real wages, and its fall in wage share of value added, suggest that what mainly happened in the manufacturing sector was a redistribution of income from labour to capital” and the fear is expressed that “[l]ower wages, rather than higher productivity, may have to bear the burden of creating competitiveness in the 1990s as a result of unsuccessful restructuring” in the 1980s (*ibid.*: 522).

<sup>17</sup> These findings confirm those by Diwan (2001). He reports, based on a large sample of countries, an average drop in the labour share of GDP per crisis of 5.0 percentage points, and a modest catch-up thereafter. In the three years after the crisis, labour shares were still 2.6 percentage points below their pre-crisis average (Diwan 2001: 6). Given the fact that most countries have undergone more than one crisis, the cumulative drop in the wage share over the last 30 years is estimated at 4.1 per cent of GDP, and is especially large for Latin America where the figure reached 6.7 per cent of GDP over the period 1970s-1990s. Thus, since many countries have undergone more than one crisis, the decline of the wage share during the crisis and the partial recovery, after the crisis has led to a secular decline in the wage share

<sup>18</sup> The weak bargaining position of labour under open capital accounts is also a causal mechanism explored by Lee and Jayadev (2005). They find that financial openness exerts a downward pressure on the labour share both in developed and developing countries for the period from 1973-1995. The effect is independent of the negative impact of financial crises.

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## 2.e The Effects of Financial Openness on Labour: Summary of Main Findings

On balance, the capital account liberalization that many developing countries embarked upon in the 1990s has delivered disappointing results. This disappointment is well summarized in a recent World Bank report that reviews the growth performance of the 1990s:

“Contrary to expectations, financial liberalization did not add much to growth, and it appears to have augmented the number of crises. As expected, deposits and capital inflows rose sharply as a result of liberalization. But, other than in a few East Asian and South Asian countries, capital markets did not provide resources for new firms. Numbers of stock market listings declined, even in the newly created markets in the transition countries that were some times used for privatizations. Also, although relevant time-series data on access are weak, and contrary to expectations, it appears that access to financial services did not improve substantially after liberalization.” (World Bank 2005b: 21)

The preceding discussion, too, has shown that capital account liberalization fell not only far short of expectations, but did serious harm to some countries and had a disproportionately negative effect on labour. Six main conclusions emerge:

(1.) In the absence of adequate institutions, the capital account liberalization has had little direct benefits for growth. This is especially true for poor countries where the institutional gap is greatest, but also for middle-income countries where capital inflows were not used to fill unmet investment needs.

(2.) However, capital account liberalization – even if managed prudently – has its cost to developing countries. In order to cushion the effects of sudden outflows, developing countries have sterilized inflows and built up large reserves. Since these are mainly held in low-yield treasury bonds issued by industrialized countries, the opportunity cost of doing so is large.

(3.) Nonetheless, capital account liberalization has left developing countries vulnerable to crisis. These are often not triggered by a sudden deterioration of a country’s so called fundamentals, but are an inherent property of the international financial system. The output losses associated with such crises are large, and even a subsequent recovery is usually insufficient to bring a country back onto its old growth path.

(4.) The negative effects of financial crisis on the labour market can be detected in a number of indicators. Open unemployment typically rises substantially during a crisis, but the impact can also be seen in a fall of real wages, rising underemployment and shifts of workers from the formal sector towards the informal economy and agriculture.

(5.) Moreover, labour markets typically lag the economic recovery by several years. Even when GDP per capita has reached its pre-crisis level, the consequences of the crisis are normally still evident from the employment indicators. This lag means that labour pays a disproportionate cost.

(6.) Tracking the evolution of the labour share in national income also shows that crises are particularly harmful for labour. As recent research indicates, financial crises have a permanent negative effect on the share of labour compensation in GDP. They are thus a factor behind the long-term trend decline in the labour share that can particularly be observed from the early 1990s onwards.

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### 3. Financial Openness and Employment: The Need for Greater Policy Coherence

The preceding sections made clear that concerns for growth, labour and employment should be more explicitly taken into account in the current financial system in order for it to perform better. Adelman (2000) argues that it might be advisable to restore a global financial environment which carries some of the characteristics of the so-called Golden Age – steady development for developing countries, combined with high stable growth for industrialized countries – while maintaining some of the virtues of a more liberalized trading and investment climate (ibid.: 1058). In order for such a system to function more efficiently in terms of growth and employment, it must have three different sets of properties:

- *Firstly, it should provide liquidity in the international system.* Liquidity is needed to respond to demands for foreign exchange and for foreign investment. In effect the downfall of the original Bretton Woods system was in part due to illiquidity of the system as a whole and the reliance on only one currency to provide liquidity.
- *Secondly, an international system should provide stability for global markets.* As indicated above the absence of stability during the last decade has caused severe and, as some have argued, even irreparable damage to the growth potential of a number of developing countries.
- *Thirdly, an international financial system should provide a large degree of policy autonomy for participating countries.* This is extremely important as countries not only have different factor endowments (capital, labour, and technology) but also different socio-economic systems. In order to find equilibrium between various policies to satisfy different economic and social demands, each country and society must be able to use the policy instruments and work with institutions which are best fitted to the country. This relates both to current conditionality as well as to difficulties countries have in applying monetary and fiscal instruments in order to achieve nationally determined economic and social goals.

The major question is, therefore, whether these required properties are compatible with each other? There is no automatism in that different sets of policies would automatically achieve all three requirements (Tinbergen's rule that the number of policy instruments must at least be equal to the number of policy targets remains as relevant as 50 years ago; see Tinbergen 1970 [1952]). *A greater sense of policy coherence is therefore called for. We can distinguish policy coherence at, and between, three different levels in order to achieve an international financial system that is more cogent of concerns for employment and labour as discussed above.* Namely, (i) policies in industrialized countries; (ii) the set of multilateral rules that has been developed since the Second World War; and (iii) policies in developing countries.

#### Policies in industrialized countries

Despite the success of emerging economies such as India and China, policies in industrialized countries and their outcomes circumscribe the economic and social policies of developing countries. Hence, even if the focus of concern is to increase the importance of employment and labour in the process of development, policies in industrialized countries need to be part of such considerations. For example, the World Commission on the Social Dimension of Globalization (2004) has indicated the following set of policies to be extremely relevant:

*More coherent economic policies between the G3 (Europe, Japan and the United States):* Uncoordinated fiscal, monetary and foreign exchange policies have created a highly vola-

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tile and instable system which is not geared towards growth and of which the spill-over effects for developing countries are serious.

*There is almost unanimous agreement that the US economy cannot be the eternal engine of growth for the rest of world. Japan and Europe should give greater reflection to growth through better coordination of fiscal and monetary policies and their effects on employment and growth and not rely only on export growth.* This would enable the United States to reduce its double deficit in a soft landing without serious repercussions for growth. Many argue that there are more structural impediments to boosting growth in the EU, but tight monetary and fiscal policies are not an answer to existing structural impediments. The effect of the deficit rules of the European Stability and Growth Pact (SGP) have thus been under much public debate. As Annett and Jaeger (2004) argue, an ideal fiscal rule would combine medium-term fiscal discipline with short-term fiscal flexibility. Assessing the SGP against this yardstick, they conclude that, generally speaking, “the pact proved conducive to fiscal discipline” and helped to bring the currency zone’s structural deficit to less than half of that of the United States and less than one quarter of Japan’s (ibid.: 23f.). They also find that the GSP delivered a “high – but certainly not perfect – degree of fiscal flexibility during the downturn” (ibid.: 24). Beetsma and Debrun (2005), who are, like Annett and Jaeger, IMF staff members, present an argument in favour of increasing the pact’s procedural flexibility to improve welfare. Allowing deviations from the “letter of the rule” laid down in the SGP could minimize the additional negative consequences of demand side shocks during economic downturns. As the European Commission (2005: 157) lays out, demand disturbances have a potentially important impact on output and unemployment in the short- to medium-term. The Commission argues that “[t]his, together with the (consensual) finding that labour market outcomes, and the unemployment rate in particular, have high persistence, raises the important issue of macroeconomic policy stabilization” (ibid.: 161).

Apart from the specific consideration of growth and employment concerns in the Stability and Growth Pact, a greater concern for growth employment creation in general is called for from all three G3 areas. In combination with a more responsible attitude in the G3 countries for enhancing growth and reducing volatility for a better functioning international financial system, *the G3 has a third important responsibility, namely, in providing development assistance and in stimulating other sources of finance to enhance growth and development and so contribute to a more properly functioning international financial system* (see World Commission on the Social Dimension of Globalization 2004: 103).

## Rules of the international system

Such changes in G3 policy stances should be embedded in changes in multilateral rules and the functioning of international financial agencies. These are discussed in detail in the report of the World Commission on the Social Dimension of Globalization (2004: 88ff.), the principles of which are:

- Capital account liberalization should depend on a country’s circumstance to maximize investment and to avoid volatility.
- In order to reduce volatility and contagion in emerging markets, the international system should have a greater resort to emergency financing.
- In order to make the international system more coherent, developing countries should be better integrated into it through:
  - greater involvement in the reform process of the international financial institutions (IFIs);
  - speeding up the process of reform;

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- removing barring caused by new codes to financial market access by developing countries;
  - providing a better system for debt reduction.

An important point in considering the rules of the international system and the policies applied by the IFIs is that the general context of the international financial landscape has changed considerably, this warrants different approaches from the decades of the 1980s and 1990s. One of the most salient points is that the continuous opening of trade, despite some recent setbacks, and the application of fairly drastic adjustment and stabilization policies in the 1980s and 1990s have dampened world wide inflationary tendencies (Akyüz 2006). In some respect, inflation rates resemble those which were current during the Golden Age of development and growth. While a decade ago, many countries belonged to the group of countries with an inflation rate of 10 per cent or higher, today very few countries belong to this group.<sup>19</sup>

Moreover, there are also few signs that inflation will re-emerge. The current opening of trade and the international agreements concluded between different countries make it unlikely for inflation to soar. Hence prices are fairly stable. But, as we discussed in the previous section, greater monetary discipline and price stability have not resulted in financial and macro-economic stability, while financial liberalization has led to increasingly sharp business cycles and sharp fluctuations in economic activity.

It is, therefore, a logical step to argue that the focus of the international system should shift from concerns on price instability to concerns for asset instability. International policies have therefore to shift. This would require firstly a greater surveillance by the IMF on asset instability and secondly a review of its approach to capital account liberalization, leading to an internationally accepted system of managed capital account liberalization. There are signs that the international policy agenda is shifting in this direction. This is evident from the World Bank (2005b) report cited above, but also from within the IMF. The Fund's Independent Evaluation Unit now sees the role played by the IMF in the past as follows:

“Throughout the 1990s, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis. [...] In multilateral surveillance, the IMF's analysis emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility.” (IMF Independent Evaluation Office 2005: 5)

The same evaluation report also describes a gradual shift in emphasis:

“More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, in the areas of macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency).” (IMF Independent Evaluation Office 2005: 3)

<sup>19</sup> In 2001 and 2002, roughly 80 per cent of the ca. 180 countries with available data had inflation rates below 10 per cent, compared to less than 50 per cent of all countries during most of the mid- to late 1970s and early 1980s, and between 50 and 60 per cent of all countries during the first half of the 1990s (based on 123 to 180 countries with available data). Today, high inflation is thus a problem for only a relatively small number of countries, and conditions are not too dissimilar from the 1960s. Back then, 85 to 90 percent of the ca. 100 to 120 countries with available data had inflation rates below 10 per cent (see World Bank, WDI 2005 on CD-Rom).

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## Policies in developing countries

Changes in rules and policies at the international level and the current low level of inflation would also allow developing countries to undertake more coherent policies in order to stimulate development, employment and growth. A potential effective set of policies would combine a flexible system of capital controls with a managed real effective exchange rate (Diwan 2001, World Bank 2005b, Charlton and Stiglitz 2004). The flexible system of capital controls would allow for more coherent national policies to be undertaken and reduce volatility which has, as we documented earlier, serious consequences not only in terms of short-term welfare losses but also in terms of reduced growth potential.

The aim of a system of a managed real effective exchange rate is to keep the industry and the economy in general at high levels of capacity utilization and so aim for full employment, as we discuss in the following paragraphs. However, before discussing the employment effects of a system of managed real effective exchange rates, we first need to address whether a coherent approach of social and economic policies is above all possible. This relates to the so-called ‘policy trilemma’ or ‘unholy trinity’ of international economic policies (see Mundell 1963; Cohen 1993; Obstfeld et al. 2004) which states that national policy space is circumscribed by the impossibility to pursue the following three policies simultaneously:

- open capital account,
- fixed exchange rates,
- an independent monetary policy,

and that only two out of these three policies can be combined. For example, under a system of an open capital account and fixed exchange rates, countries can not pursue an independent monetary policy since interest rates are determined by world interest levels. Conversely, if countries need to undertake an independent monetary policy, they have either to revert to flexible exchange rates or opt for a closed capital account.

However, some more recent research argues that the *policy trilemma*, which has been guiding national and international policy makers for several decades, *can be relaxed by avoiding corner solutions*. This would imply to go beyond the traditional alternatives of fixed versus flexible exchange rates, or open versus closed capital accounts, and to adopt intermediate options in these three policy domains – like a capital account management through the selective application of capital controls, or a managed real exchange rate (see Bradford 2004). For example, in the case of China, research from the IMF argues that making the quasi-fixed exchange rate more flexible would allow the country to pursue a more independent monetary policy. The same paper also argues for a cautious approach to capital account liberalization, given institutional weaknesses of China’s financial system (see Prasad et al. 2005). The argument could be extended to many other developing countries. Rather than abandoning capital controls altogether, they should therefore remain a policy tool that can be used selectively.

Although capital controls have, much like any other policy instrument, not always been fully effective in reaching their stated objectives (see Ariyoshi et al. 2000), they have contributed to regaining greater policy autonomy in several cases. For example, controls imposed on inflows have helped to reduce their level and to change the composition of inflows towards longer maturities in Chile, hence increasing the autonomy of monetary policy (Gallego et al. 1999; see also de Gregorio et al. 2000). An important side-effect is that the level of international reserves can be reduced when the amount of short-term liabilities falls, lowering the opportunity cost of reserve holdings. An important lesson is that controls need to have comprehensive coverage and be forcefully implemented to be effective (Ariyoshi et al. 2000: 17). The more controversial issue is controls on outflows, but Edison

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and Reinhart (2001) argue that such controls have enabled Malaysia to stabilize exchange rates and interest rates during the East Asian crisis and to gain more policy autonomy. Kaplan and Rodrik (2001) conclude that the Malaysian approach has led to a faster economic recovery and smaller declines in real wages and employment than IMF policies would have.<sup>20</sup> More generally, if applied soundly, a *managed capital account* can help to avoid financial crises or contain their impact, and hence contribute to a stable investment climate, sustained growth and employment creation.

How could a system of a *managed real exchange rate*, the second element mentioned earlier, affect employment? Rodrik (2003) and Frenkel (2004) provide three channels. Active management of the real exchange rate...

- will allow for higher capacity utilization in times of unemployment, if it is applied in combination with the appropriate mix of macroeconomic and fiscal policies;
- will stimulate output growth and hence employment, if it is combined with appropriate industrial policies, as the experience in various Asian countries has shown (Amsden 2001);
- will affect the sectoral composition of exports towards more labour intensive goods, and hence increase the employment elasticity of the economy, as a whole, compared to another system.<sup>21</sup>

Employing a policy mix with intermediate options such as a managed capital account and a managed real exchange rate requires more fine tuning and coherence in policies rather than relying on rule-of-thumb policy interventions. While this can help to avoid corner solutions, it necessitates national institutions with explicit mandates and capabilities to achieve this. Another possible, supplementary element to relax the policy trilemma would be to include one or two additional policy instruments to complement the fiscal and monetary tools (see also Tinbergen 1970 [1952]: 40f.). Bradford (2004) suggests, for example, social pacts or coordinated wage bargaining to hold down inflation and so to “free up” other policies to aim at growth and employment creation. Also, a greater concern for inequity and a reduction of national inequalities could contribute to reducing inflationary pressure and could be added either as part of a social pact or as a stand-alone policy instrument (see van der Hoeven and Saget 2004). This, too, requires institutional capability.

### Building institutions for coherent policies

The conclusions of these deliberations is that a coherent approach in national and international financial policies to stimulate employment growth is well possible, but requires different rules, better fine tuning of different components of national policies, and appropriate institutions. For national institutions to function well, one can point to two distinct national configurations: Theoretically, one configuration would be a repressive state with a strong and autonomous bureaucracy that is able to coordinate a well functioning and coherent set of policies. The other would be a national system of consensus and willingness for policy dialogue that can design a coherent set of policies that are acceptable to citizens, and can therefore be implemented without resort to authoritarian methods.

<sup>20</sup> For a detailed review of the Malaysian experience see Jomo (2005). For a comprehensive discussion of the management of capital flows in developing countries and policy conclusions see UNCTAD (2003).

<sup>21</sup> This is a comparative static argument comparing two equilibria under different policy regimes. This is independent of a secular decline of employment elasticity, which various observers have been discussing.

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The authoritarian path is neither desirable nor viable in the long run; it would often mean the violation of basic human rights (such as freedom of speech and association), and would not be internationally accepted either (see the report of the Commission on Human Security 2003). Hence the configuration of an open and consensus prone society is the only feasible option in the long run. Building institutions that formulate policies in a consensus-driven and democratic way is neither a straightforward nor a simple task. But then, as the widespread failure of implementing structural adjustment policies has shown, neither are orthodox policy packages. One obstacle is that reaching consensus is particularly difficult in unequal societies. Hence, by giving more attention to distributional issues, policy can reduce inequality and lay the ground to the better implementation of economic policies and to greater policy coherence.

Labour market institutions can play an important role in achieving this objective. Van der Hoeven and Saget (2004) argue for three efficiency criteria to evaluate the efficiency of labour market policies, namely allocative efficiency (matching supply and demand to reduce unemployment), dynamic efficiency (quality of the future labour force) and equity efficiency (containing inequalities). Many neoclassical economists evaluate labour market systems only on the basis of allocative efficiency, but Freeman (2000) observes in evaluating labour market institutions in more advanced countries, that the first order result of labour market institutions is distributional and the second order result is economic efficiency. Therefore, societies do not have to decide, on economic efficiency grounds, what type of labour market system to adopt, and can let distributional considerations play an important role in designing an appropriate labour market system. Dagdeviren et al. (2002) demonstrate that these need not be a trade-off between redistribution and growth, and that national socio-economic structures should determine the proper mix of growth and redistributive policies. This point was recently underscored by the United Nations' Report on the World Social Situation (United Nations 2005).

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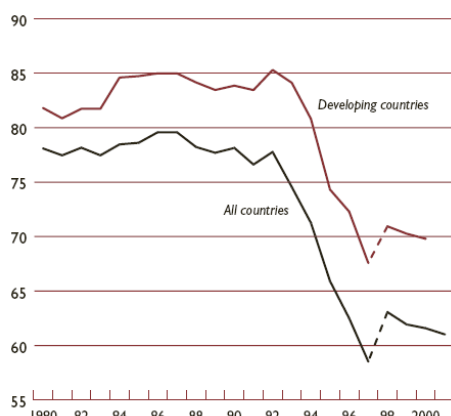
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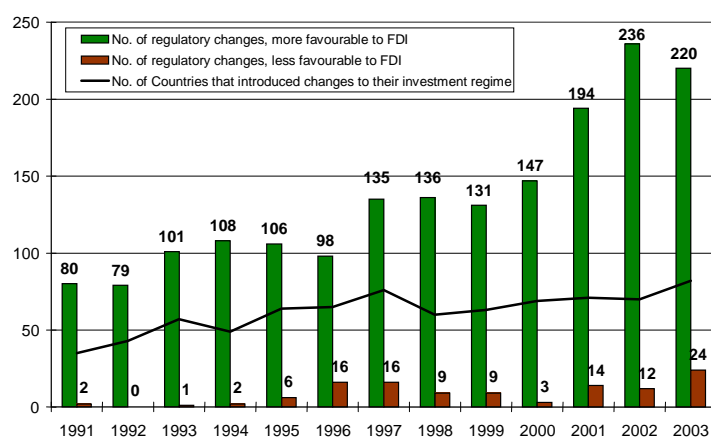
## Statistical Annex

**Annex Graph 1: Countries with Capital Controls, 1980-2001 (in % of total IMF membership)**



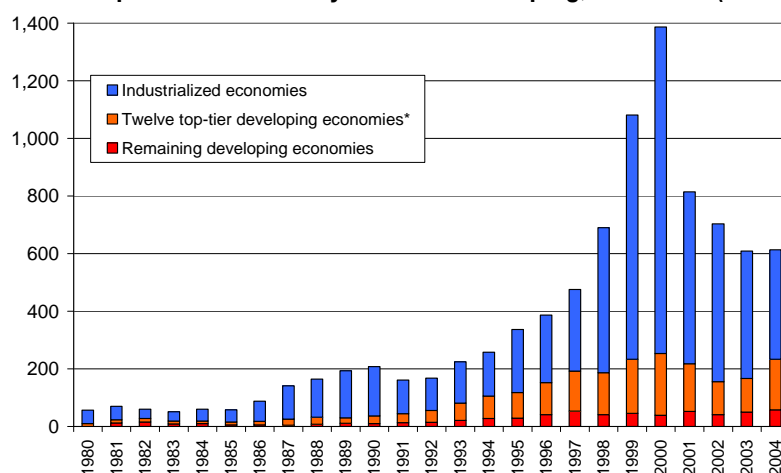
Source: IMF Independent Evaluation Office (2005). Based on a one (controlled) or zero (not controlled) classification (covering all capital account transactions), as provided by the AREAER. There was a definitional change from 1997 to 1998.

**Annex Graph 2: National Regulatory Changes towards FDI, 1991-2003**



Source: UNCTAD, World Investment Report 2004, p. 8.

**Annex Graph 3: FDI Inflows by Economic Grouping, 1980-2003 (in billion current US\$)**



\* Identified according to their total FDI inflows during the 1990s; they are: China, Brazil, Mexico, China (Hong Kong SAR), Singapore, Argentina, Malaysia, Bermuda, Chile, Thailand, Rep. of Korea and Venezuela.

Source: UNCTAD Handbook of Statistics 2005 on CD-Rom.

**Annex Table 1: Gross Private Capital Flows, 1977-2004 (in % of GDP)**

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003	2004
<b>World</b>	6.2	7.7	9.2	11.2	18.5	28.4	22.0	21.1	24.5	28.4
<b>High income</b>	6.4	8.1	10.1	11.8	20.4	32.3	24.6	23.4	27.5	32.0
<b>Low &amp; middle income</b>	5.3	5.5	4.7	7.6	10.4	11.4	11.2	10.8	11.3	11.9
<b>Middle income</b>	6.5	6.4	5.2	8.2	11.2	11.9	12.0	11.6	12.1	12.2
<b>Low income</b>	1.7	2.1	2.7	4.2	5.4	7.8	6.1	6.2	6.9	..
<b>East Asia &amp; Pacific</b>		3.1	3.8	8.0	10.5	12.8	10.3	9.1	11.8	9.4
<b>Europe &amp; Central Asia</b>	4.0	2.5	6.2	..	11.9	14.5	13.1	14.1	16.4	18.8
<b>Latin America &amp; Caribbean</b>	7.1	9.5	7.2	9.2	11.8	10.8	12.6	13.3	9.8	10.4
<b>Middle East &amp; North Africa</b>	7.4	3.2	2.9	7.2	5.5	5.9	..	..	..	..
<b>South Asia</b>	0.4	0.6	1.2	2.9	3.8	6.5	5.0	4.2	5.4	..
<b>Sub-Saharan Africa</b>	2.8	4.1	5.6	6.9	13.5	13.4	16.1	13.3	11.5	9.5

Source: World Bank, *World Development Indicators* online database, as of May 2006 (Washington, DC, 2006).

Note: Gross Private Capital Flows are defined as "the sum of the absolute values of direct, portfolio, and other investment inflows and outflows recorded in the balance of payments financial account, excluding changes in the assets and liabilities of monetary authorities and general government" (*ibid.*). Figures for the periods from 1997 to 1999 are arithmetic averages; figures in *italics* refer to 1982-1984 (East Asia & Pacific) and 1985-1988 (Europe & Central Asia), respectively.

**Annex Table 2: Gross Fixed Capital Formation, 1977-2004 (in % of GDP)**

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003	2004
<b>World</b>	23.9	22.8	22.2	21.7	21.6	21.8	21.2	20.3	20.4	..
<b>High income</b>	23.8	22.8	22.1	21.4	21.2	21.6	20.9	19.9	19.8	..
<b>Low &amp; middle income</b>	24.2	23.1	22.8	23.3	23.4	22.9	22.5	22.2	23.0	23.9
<b>Middle income</b>	25.2	24.0	23.4	23.7	23.8	23.2	22.7	22.4	23.1	24.2
<b>Low income</b>	18.1	18.3	19.3	20.4	21.0	20.9	21.3	21.4	21.8	22.5
<b>East Asia &amp; Pacific</b>	27.8	28.0	28.1	31.1	31.4	29.8	30.1	31.0	33.1	33.8
<b>Europe &amp; Central Asia</b>	..	..	..	22.3	21.8	21.1	20.5	19.6	19.5	20.1
<b>Latin America &amp; Caribbean</b>	22.9	20.6	19.5	19.0	19.7	20.1	18.8	17.8	17.9	19.5
<b>Middle East &amp; North Africa</b>	29.7	26.0	22.5	21.5	21.8	21.4	21.4	21.4	22.3	22.9
<b>South Asia</b>	17.5	18.9	20.6	21.4	21.7	21.7	21.5	21.6	21.9	22.9
<b>Sub-Saharan Africa</b>	24.6	21.7	17.8	17.5	17.7	16.7	17.6	17.7	18.1	18.4

Source: World Bank, *World Development Indicators* online database, as of May 2006 (Washington, DC, 2006).

Note: Gross Fixed Capital Formation is defined to include "land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. According to the 1993 SNA, net acquisitions of valuables are also considered capital formation" (*ibid.*). Figures for the periods from 1997 to 1999 are arithmetic averages.

**Annex Table 3: Net Private Capital Flows to Low and Middle Income Countries, 1975-2003 (in billion current US\$)**

	1975-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003
<b>Low &amp; middle income</b>	33.6	47.6	30.6	102.2	235.5	186.0	174.3	160.3	199.4
<b>Middle income</b>	30.5	41.9	24.6	94.2	221.0	170.9	160.8	146.3	177.9
<b>Low income</b>	3.1	5.7	6.1	8.0	14.4	15.1	13.5	14.0	21.5
<b>East Asia &amp; Pacific</b>	3.7	8.4	9.8	42.2	69.0	35.9	36.6	47.1	62.0
<b>Europe &amp; Central Asia</b>	3.3	5.5	5.0	12.6	41.5	42.0	37.7	55.4	67.1
<b>Latin America &amp; Caribbean</b>	18.9	25.5	5.9	38.2	102.9	82.7	71.3	35.6	41.1
<b>Middle East &amp; North Africa</b>	4.5	2.8	4.1	2.2	3.3	5.3	9.4	8.1	4.8
<b>South Asia</b>	0.1	1.7	3.7	4.7	6.9	9.7	5.2	6.5	11.1
<b>Sub-Saharan Africa</b>	3.2	3.8	2.2	2.3	11.8	10.4	14.0	7.6	13.2

Source: World Bank, *World Development Indicators 2005 on CD-Rom* (Washington, DC, 2005), based on series 'Private capital flows, net total (current US\$)'.

Note: Net Private Capital Flows are defined to "consist of private debt and nondebt flows. Private debt flows include commercial bank lending, bonds, and other private credits; nondebt private flows are foreign direct investment and portfolio equity investment. Data are in current U.S. dollars" (ibid.).

**Annex Table 4: International Reserve Holdings by Low and Middle Income Countries, 1977-2004 (in % of GNI)**

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003	2004
<b>Low &amp; middle income</b>	6.0	5.0	4.4	6.9	11.0	12.2	13.3	16.0	18.5	20.7
<b>Middle income</b>	5.7	4.4	3.6	4.6	7.2	9.1	10.2	12.8	15.3	17.0
<b>Low income</b>	6.0	5.1	4.6	7.3	11.6	12.7	13.9	16.5	19.1	21.4
<b>East Asia &amp; Pacific</b>	6.4	7.8	8.3	11.9	15.6	16.9	18.7	21.4	25.1	30.6
<b>excl. China</b>	10.1	8.4	10.4	15.1	18.8	22.7	23.6	23.3	24.0	26.0
<b>China</b>	3.5	7.2	6.8	9.0	14.1	14.5	16.9	20.7	25.5	32.3
<b>Europe &amp; Central Asia</b>	..	..	..	..	10.1	13.8	14.4	16.8	18.3	19.2
<b>Latin America &amp; Caribbean</b>	8.3	6.7	6.2	7.2	8.9	8.4	8.8	10.1	11.9	11.7
<b>Middle East &amp; North Africa</b>	21.3	11.1	5.8	11.8	13.8	13.7	15.5	19.0	22.4	22.9
<b>South Asia</b>	6.1	4.7	3.8	4.7	6.7	7.9	9.3	13.2	16.1	17.3
<b>Sub-Saharan Africa</b>	6.2	5.0	4.2	5.7	8.5	11.8	11.8	11.4	10.3	13.0

Source: World Bank, *Global Development Finance*, online database as of May 2006 (Washington, DC, 2006); based on series 'International Reserves (US\$)' and 'Gross National Income (US\$)'; international reserves include 'monetary authorities holdings of special drawing rights (SDRs), its reserve position in the IMF, its holdings of foreign exchange, and its holdings of gold (valued at year-end London prices)'.