

THIRD WORLD *Economics*

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BIS calls for building economic resilience, maintaining globalization

The global economy has strengthened but still faces risks to growth which require policy measures to build greater economic resilience, says the Bank for International Settlements (BIS). In its 87th Annual Report, released in June, the BIS also launches a defence of globalization, arguing that it has helped raise living standards and should be properly managed instead of being rolled back.

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Use prevailing tailwinds to build greater economic resilience, says BIS

While the world economy has gained strength, risks to global growth exist which necessitate national and international policy measures to build resilience, according to the Bank for International Settlements (BIS).

by Chakravarthi Raghavan

GENEVA: Over the past year the global economy has strengthened further, with growth approaching long-term averages, but faces risks that could threaten the sustainability of the expansion in the medium term, the Bank for International Settlements (BIS) says in its 87th Annual Report, released on 25 June.

"The most promising policy strategy to counter the risks is to take advantage of the prevailing tailwinds to build greater economic resilience, nationally and globally," adds the Basel (Switzerland)-based BIS, commonly referred to as the central bank for the world's central banks.

The full report was presented to its annual general meeting on 25 June. Chapter VI of the report, titled "Understanding globalization", had been released separately a week earlier, in a departure from the usual practice of issuing the report as a whole (see following article).

That chapter, focussing directly on globalization and the "unjustified backlash" against it in the advanced economies, advocates careful management of risks to ensure continued openness of economies to trade and finance which have been "instrumental in raising living standards and helped lift large parts of the world population out of poverty."

The focus on globalization and the backlash appears to reflect the concerns of the BIS management and its constituent central banks that in the current state of politics and public debates in the advanced economies, there will be concerted efforts by some governments to rein in and discipline financial institutions, putting the brakes on financial globalization.

The same theme seemed to run through the entire report, as well as the speeches and remarks at the annual general meeting by BIS General Manager Jaime Caruana and two BIS economists – Claudio Borio, Head of the Monetary and Economic Department, and Hyun

Song Shin, Economic Adviser and Head of Research. All three underscored that trade openness and financial openness were symbiotic and went together, and putting the brakes on one would have effects on the other.

In his speech, Caruana said the report aimed to "contribute to the debate on the global economy among policymakers, the private sector and academics." The nature of this debate, he added, has changed a lot over the last year and the criticism of globalization seems to have gained prominence.

However, the intensified debate and criticism of globalization over the past year among "policymakers, the private sector and academics" appears to reflect these groups' belated catching-up on the long-ignored deeper undercurrents of grievance among the public over stagnant or falling real incomes and living standards of the working and middle classes whilst a minuscule minority at the top reaps benefits.

The Brexit vote in the UK and the outcome of the US presidential election (both noted in the BIS report) are perhaps mere manifestations that caught by surprise the elites, who are now attempting to understand it and consider how to counter it.

The backlash against financial globalization, in particular, appears to be related mainly to the trade in finance and financial products (derivative instruments of great complexity, used mainly for speculation) which are delinked from the real economy but which can have very real consequences for taxpayers, such as during the Great Financial Crisis (GFC) when taxpayers were forced to pick up the tab for the misbehaviour and failures of financial firms.

In focussing on the backlash to globalization, Caruana (like the BIS report) suggested that the current global upturn in growth provides opportunities, and the tailwinds should be used to "marshal support for economic openness and pay

more attention to long-term developments”, pursuing policies that build economic resilience, so as to be better prepared for the next “shock” or downturn.

Risks to global growth

In the report, the BIS suggests that the facts paint a brighter picture. There are clear signs that growth has gathered momentum. Economic slack in the major economies has diminished further; indeed, in some of them unemployment rates have fallen back to levels consistent with full employment. Inflation readings have moved closer to central bank objectives, and deflation risks no longer figure in economic projections. But sentiment has swung even more than facts. Gloom has given way to confidence.

The report identifies four risks to global growth: a rise in inflation; financial stress as financial cycles mature; weaker consumption and investment, mainly under the weight of debt; and a rise in protectionism. These risks, it adds, are rooted in what it calls the “risky trinity”: unusually low productivity growth, unusually high debt levels, and unusually limited room for policy manoeuvre.

Evaluating the risks, the BIS says that a significant rise in inflation could choke the expansion by forcing central banks to tighten policy more than expected. Secondly, serious financial stress could materialize as financial cycles mature if their contraction phase were to turn into a more serious bust – as happened most spectacularly with the GFC. Thirdly, short of serious financial stress, consumption might weaken under the weight of debt (and the global debt-to-GDP ratio is increasing), and investment might fail to take over as the main growth engine. Finally, a rise in protectionism could challenge the open global economic order. History shows that trade tensions can sap the global economy’s strength.

These risks, the BIS says, may appear independent, but they are not. Policy tightening to contain an inflation spurt could trigger or amplify a financial bust in the more vulnerable countries. The strong post-crisis expansion of dollar-denominated debt has raised vulnerabilities, particularly in some emerging market economies (EMEs). An overarching issue is the global economy’s sensitivity to higher interest rates given the continued accumulation of debt in relation to GDP, complicating the policy normalization process. A withdrawal

into trade protectionism could spark financial strains and make higher inflation more likely. And the emergence of systemic financial strains yet again, or simply much slower growth, could heighten the protectionist threat beyond critical levels.

Given the risks ahead, the BIS says, the most promising policy strategy is to take advantage of the prevailing tailwinds to build greater economic resilience, nationally and globally. At the national level, this means rebalancing policy towards structural reforms, relieving an overburdened monetary policy, and implementing holistic policy frameworks that tackle more systematically the financial cycle. At the global level, it means reinforcing the multilateral approach to policy – the only one capable of addressing the common challenges the world is facing.

Assessing the economic developments of the past year, the report says that the change in financial market sentiment was remarkable. Equally remarkable was the shift in the main forces driving markets. Politics, notably the UK vote to leave the European Union (Brexit) and above all the US election, took over from central banks.

Correspondingly, the “risk-on”/“risk-off” phases, so common post-crisis in response to central banks’ words and actions, gave way to a more differentiated pattern in sync with political statements and events. That said, central banks continued to exert a significant influence on markets.

In terms of sustainability of the growth momentum, the BIS says that its brief review of economic developments of the past year indicates that the global economy’s performance has improved considerably and that its near-term prospects appear to be the best in a long time.

The central scenario delineated by private and official sector forecasts points to further gradual improvement: headwinds abate, the global economy gathers steam, monetary policy is gradually normalized, and the expansion becomes entrenched and sustainable. Indeed, the financial market sentiment is broadly consistent with this scenario.

Assessing the risks of a spurt in inflation, the BIS says that since the great financial crisis and its effects, there are *prima facie* reasons to believe that inflation, already edging up, could increase significantly. More importantly, economic slack is vanishing, and this is happening in several countries simulta-

neously, suggesting that it would be unwise to take much comfort from the fact that higher inflation has recently mirrored mainly a higher oil price: they could point to greater inflation momentum going forward.

At the same time, a substantial and lasting flare-up of inflation does not seem likely. While the deeper reasons for these developments are not well understood and an inflation spurt cannot be excluded, it may not be the main factor threatening the expansion, at least in the near term. Judging from what is priced in financial assets, financial market participants also appear to hold this view.

In this light, the potential role of financial cycle risks comes to the fore. The main cause of the next recession will perhaps resemble more closely that of the latest one – a financial cycle bust.

Such risks are not apparent in the countries at the core of the GFC (the US, the UK or Spain), where some private sector deleveraging has taken place and financial cycle expansions are still comparatively young. The main source of near-term concerns in crisis-hit economies is the failure to fully repair banks’ balance sheets in some countries, notably in parts of the euro area, especially where the public sector’s own balance sheet looks fragile.

Rather, the classical signs of financial cycle risks are apparent in several countries largely spared by the GFC, comprising several EMEs, including the largest, as well as a number of advanced economies, notably some commodity exporters. In all of these economies, interest rates have been very low, or even negative, as inflation has stayed low or even given way to deflation, despite strong economic performance.

Financial cycles in this group are at different stages. In some cases, such as China, the booms are continuing and maturing; in others, such as Brazil, they have already turned to bust and recessions have occurred, although without ushering in a full-blown financial crisis.

EMEs face an additional challenge: the comparatively large amount of foreign exchange (FX) debt, mainly in US dollars. From 2009 to end-2016, dollar credit to non-banks located outside the United States – a bellwether BIS indicator of global liquidity – soared by around 50% to some \$10.5 trillion; for those in EMEs alone, it more than doubled, to \$3.6 trillion.

Compared with the past, several factors mitigate the risk linked to FX debt.

Countries have adopted more flexible exchange rate regimes and have also built up foreign currency war chests, which should cushion the blow if strains emerge. And the amounts of FX debt in relation to GDP are, on balance, still not as high as before previous financial crises.

More generally, while leading indicators of financial distress provide a general sense of a build-up of risk, they have a number of limitations. In particular, they tell us little about the precise timing of its materialization, the intensity of strains or their precise dynamics. Also, policymakers have taken major steps post-crisis to improve the strength of regulatory and supervisory frameworks. Many EMEs have had recourse to a wide array of macro-prudential measures to tame the financial cycle. While these have not succeeded in avoiding the build-up of outsize financial booms, they can make the financial system more resilient to the subsequent bust. As the experience of Brazil indicates, this may not prevent a recession, but it may limit the risk of a financial crisis. These limitations suggest that the indicators need to be treated with caution.

Short of any serious financial strains, the expansion could end because of weakness in domestic aggregate demand.

In many countries, the recent expansion has been consumption-led, with consumption growth outpacing that of GDP. By contrast, investment has been comparatively subdued until recently. Could consumption weaken? And what are the prospects for a sustained strengthening of investment?

While consumption could weaken as a result of smaller employment gains as capacity constraints are hit, the more serious vulnerabilities reflect the continued accumulation of debt, sometimes on the back of historically high asset prices. BIS research has uncovered an important but under-appreciated role of debt service burdens in driving expenditures, pointing to vulnerabilities.

These are apparent in economies that have experienced household credit booms post-crisis, often alongside strong property price increases, including several small open economies and some EMEs.

Increases in interest rates beyond what is currently priced in markets could weaken consumption considerably. By contrast, in some crisis-hit countries, such as the United States, the safety cushion is considerably larger following the

deleveraging that has already taken place.

While interest rates matter for investment, a bigger role is played by profits, uncertainty and cash flows. In EMEs, a cause for concern has been the sharp increase in corporate debt in several economies, sometimes in foreign currency. China stands out, given the combination of unprecedented debt-financed investment rates and signs of excess capacity and unprofitable businesses. A sharp slowdown there could cause much broader ripples in EMEs, including through a slump in commodity prices.

Since the GFC, protectionist arguments have been gaining ground. They have been part of a broader social and political backlash against globalization. Rolling back globalization would strike a major blow against the prospects for a sustained and robust expansion. Investment would be the first casualty, given its tight link with trade. But the seismic change in institutional frameworks and policy regimes would have a broader and longer-lasting impact.

Real and financial globalization intertwined

While there is a natural tendency to discuss real and financial globalization separately, the two are intertwined. Exports and imports rely heavily on international financing. Transnational ownership of companies through foreign direct investment (FDI) boosts trade, spreads organizational and technological know-how, and gives rise to global players. Banks and other service providers tend to follow their customers across the world.

Financial services are themselves an increasing portion of economic activity and trade. And the relevance of national borders is further blurred by the overwhelming use of a handful of international currencies, mostly the US dollar, as settlement medium and unit of account for trade and financial contracts.

(Some of the propositions and arguments above seem questionable, however. – *SUNS*)

Across countries, the pattern of financial linkages mirrors rather well that of trade. Historically, there have been periods, such as the Bretton Woods era, in which policymakers sought greater trade integration while at the same time deliberately limiting financial integration, so as to retain more policy autonomy. But, over time, the regimes proved unsustainable, and financial in-

tegration grew apace. That said, the financial side has also developed a life of its own.

Across countries, this reflects in particular the benefits of agglomeration, which cause financial activity to concentrate in financial centres, and tax arbitrage, which encourages companies to locate headquarters in specific countries. Since the early 1990s financial linkages have far outstripped trade, in contrast to what available data suggest about the first globalization wave (that ended with World War I).

There is some evidence that globalization has slowed post-crisis, but it is not in retreat. Trade in relation to world GDP and global value chains (GVCs) have plateaued. And while financial integration broadly defined seems to have moderated, bank lending has pulled back. However, a closer look at the BIS statistics indicates that the contraction largely reflects a pullback by euro area banks and is regional in nature. Banks from Asia and elsewhere have taken over, and integration has not flagged. Moreover, securities issuance has outpaced bank lending, in line with the rise of institutional investors and asset managers.

From a policy perspective, the reasons for the slowdown matter. The slowdown would be less of an issue if it simply reflected cyclical factors and unconstrained economic decisions. Much of the decline in trade and financial linkages seems to have that character. It would be more of a concern if it reflected national biases. In both trade and finance, there are signs that this too may have started to occur. Hence, the increase in trade restrictions and in ring-fencing in the financial sector. No doubt some of those decisions may be justified, but they could herald a broader and more damaging backlash.

Formal statistical evidence, casual observation and plain logic indicate that globalization has been a major force supporting world growth and higher living standards. Globalization has helped lift large parts of the world population out of poverty and reduce inequality between countries.

At the same time, it is also well known that globalization poses challenges. Firstly, its benefits may be unevenly distributed, especially if economies are not ready or able to adapt. Trade displaces workers and capital in those sectors that are more exposed to international competition. And it may also increase income inequality in some coun-

tries. Opening up trade with countries where labour is abundant and cheap puts pressure on wages in those where it is scarcer and more expensive. It can thus erode labour's pricing power, tilt the income distribution towards capital, and widen the skilled/unskilled labour wedge.

Secondly, opening up the capital account without sufficient safeguards can expose the country to greater financial risks. The empirical evidence confirms, but also qualifies, the impact on labour markets and income distribution.

And while studies have found an impact on income inequality, they have generally concluded that technology has been much more important: the mechanisms are similar and naturally interact, but the spread of technology across the whole economy has made its influence more pervasive.

It is also well recognized by now that greater financial openness can channel financial instability. Just as with domestic financial liberalization, unless sufficient safeguards are in place, it can increase the amplitude of financial booms and busts – the so-called “procyclicality” of the financial system. The free flow of financial capital across borders and currencies can encourage exchange rate overshooting, exacerbate the build-up of risks and magnify financial distress – that is, increase the system's “excess elasticity”. The dominant role of the US dollar as international currency adds to this weakness, by amplifying the divergence between the interests of the country of issue and the rest of the world. Hence, the outsize influence of US monetary policy on monetary and financial conditions globally.

These side-effects of globalization do not imply that it should be rolled back; rather, they indicate that it should be properly governed and managed. A roll-back would have harmful short-term and long-term consequences. In the short term, greater protectionism would weaken global demand and jeopardize the durability and strength of the expansion, by damaging trade and raising the spectre of a sudden stop in both investment and FDI. In the longer term, it would endanger the productivity gains induced by greater openness and threaten a revival of inflation.

Building resilience

Given the risks ahead, how can policymakers best turn the current upswing into sustainable and robust glo-

bal growth? Over the past year, a broad consensus has been emerging about the need to rebalance the policy mix, lightening the burden on monetary policy and relying more on fiscal measures and structural reforms. Still, views differ about policy priorities.

Much of the current policy discourse revolves around two propositions. The first is that policymakers are able to finetune the economy, by operating levers that influence aggregate demand, output and inflation in a powerful and predictable way. The second is that there is a neat distinction between the short run, the preserve of aggregate demand, and the long run, the preserve of aggregate supply.

There is clearly some truth in both propositions, though reality is much more nuanced. It is all too easy to overestimate policymakers' ability to steer the economy. Moreover, aggregate demand and supply interact so that the short and long run blend into each other.

The post-crisis experience has proved that it is much harder than expected to boost growth and inflation despite unprecedented measures. And the recession, itself the legacy of the previous unsustainable financial boom, appears to have left profound scars: output losses have been huge and productivity growth persistently weakened.

This experience highlights the need to evaluate policy in a long-term context. Rather than seeking to finetune the economy, a more promising approach would be to take advantage of the current strong tailwinds to strengthen the economy's resilience, at both the domestic and global level. Resilience, broadly defined, means more than just the capacity to withstand unforeseen developments or “shocks”. It also means reducing the likelihood that shocks will materialize in the first place, by limiting policy uncertainty and the build-up of vulnerabilities, such as those stemming from financial imbalances. And it means increasing the economy's adaptability to long-term trends, such as those linked to ageing populations, slowing productivity, technology or globalization.

Building resilience domestically is a multifaceted challenge involving monetary, fiscal and structural policies as well as their role in tackling the financial cycle. There is a broad consensus now that monetary policy has been overburdened for far too long. In the process, central bank balance sheets have become bloated, policy interest rates have been ultra-low for a long time, and central

banks have extended their direct influence way out along the sovereign yield curve as well as to other asset classes, such as private sector debt and even equity.

Building resilience would suggest attaching particular importance to enhancing policy space, so as to be better prepared to tackle the next recession. This, in turn, would suggest taking advantage of the economy's tailwinds to pursue normalization with a steady hand as domestic circumstances permit.

Normalization presents a number of tough challenges. Many of them stem from the journey's starting point – the unprecedented monetary conditions that have prevailed post-crisis. Heightened uncertainty naturally induces central banks to move very gradually with interest rates, and even more so with their balance sheets, with changes that are well telegraphed. On the other hand, that very gradualism implies a slower build-up of policy space. And it may also induce further risk-taking and promote the conditions that make a smooth exit harder. Trade-offs are further complicated by the spillovers that domestic actions may have globally, especially in the case of the US dollar.

As a result, the road is bound to be bumpy. Normalization may well not proceed linearly, but in fits and starts, as central banks test the waters in light of evolving conditions. And yet it is essential for financial markets and the broader economy to shake off their unusual dependence on central banks' unprecedented policies.

Building resilience through fiscal policy has two dimensions. The first is to prioritize the use of any available fiscal space to support growth-friendly structural reforms; reinforce support for globalization by addressing the dislocations it can cause; last but not least, public support for balance sheet repair remains a priority where private sources have been exhausted. Resolving non-performing loans is paramount for unlocking the financing of productive investments.

What would be unwise at the current juncture would be simply to resort to deficit spending where the economy is close to full employment. This does not rule out the streamlining of tax systems or judicious and well-executed public investments. But, as always, implementation is of the essence and far from straightforward, as the historical record suggests.

The second dimension concerns en-

hancing fiscal space over time. A precondition is its prudent measurement, incorporating in current methodologies a number of factors that tend to be underplayed or excluded – the need for a buffer for potential financial risks, realistic financial market responses to higher sovereign risks, and the burden of ageing populations. A prudent assessment of fiscal space could anchor the needed medium-term consolidation of public finances.

Building resilience through structural policies is essential. Unfortunately, far from speeding up, implementation has been slowing down. The needed structural reforms are largely country-specific. Their common denominator is fostering entrepreneurship and the rapid take-up of innovation, limiting rent-seeking behaviour.

In addition, an under-appreciated aspect is to ensure the flexible reallocation of resources, given the debilitating impact rigidities can have on the economy's shock-absorbing capacity and on productivity growth. Steps in that direction would also go a considerable way towards addressing the dislocations from globalization.

It would be important that monetary, fiscal and even structural measures be part of a shift towards policy frameworks designed to address a critical source of vulnerabilities – the financial cycle. Tackling the financial cycle would call for more symmetrical policies. Otherwise, over long horizons, failing to constrain financial booms but easing aggressively and persistently during busts could lead to successive episodes of serious financial stress, a progressive loss of policy ammunition and a debt trap.

From this perspective, there are some uncomfortable signs: monetary policy has been hitting its limits; fiscal positions in a number of economies look unsustainable, especially if one considers the burden of ageing populations; and global debt-to-GDP ratios have kept rising.

Global challenges need clear rules of the game

While there is a lot that domestic policy can do to build resilience, certain challenges call for a global response. The goal is to set out a clear and consistent multilateral framework – the rules of the game – for actions to be taken either at the national level or jointly internationally.

A first priority is to finalize the fi-

nancial (prudential) reforms under way. A core of common minimum standards in the financial sphere is a precondition for global resilience in an integrated financial world. Such standards avoid a perilous race to the bottom. Among the reforms, completing the agreement on minimum capital and liquidity standards – Basel III – is especially important, given the role banks play in the financial system.

The task is to achieve agreement without, in the process, diluting the standards in the false belief that this can support growth. A sound international agreement, supported by additional measures at the national level, combined with the deployment of effective macroprudential frameworks, would also reduce the incentive to roll back financial integration.

A second priority is to ensure that adequate crisis management mechanisms are in place. A critical element is the ability to provide liquidity to contain the propagation of strains. And that liquidity can only be denominated in an international currency, first and foremost the US dollar, given its dominant global role. At a minimum, this means retaining the option of activating, when circumstances require, the inter-central bank swap arrangements implemented post-crisis.

A third priority is to ensure that open trade does not become a casualty of protectionism. A key to postwar economic success has been increased trade openness built around the multilateral institutions that support it. The arrangements are by no means perfect. For instance, the World Trade Organization's global trading rounds have ground to a halt and its dispute settlement mechanism is overburdened. Even so, it would be a mistake to abandon multilateralism: the risk of tit-for-tat actions is simply too great. While open trade creates serious challenges, rolling it back would be just as foolhardy as rolling back technological innovation.

A fourth, complementary priority is to seek a more level playing field in taxation. Tax arbitrage across jurisdictions is one factor that has fuelled resentment of globalization and has no doubt contributed to income and wealth inequality within countries, including by encouraging a race to the bottom in corporate taxation. Several initiatives have been under way under the aegis of the G20. But efforts in this area could be stepped up.

Beyond these priorities, it is worth exploring further the room for greater monetary policy cooperation – the fifth area. Cooperation would help limit the disruptive build-up and unwinding of financial imbalances. In increasing degree of ambition, options include enlightened self-interest, joint decisions to prevent the build-up of vulnerabilities, and the design of new rules of the game to instil more discipline in national policies.

While the conditions for tighter forms of cooperation are not fulfilled at present, deepening the dialogue to reach a better agreement on diagnosis and remedies is a precondition for further progress.

These courses of action recognize that, just like technology, globalization is an invaluable common resource that offers tremendous opportunities. The challenge is to make sure that it is perceived as such rather than as an obstacle, and that those opportunities are turned into reality.

It is dangerous for governments to make globalization a scapegoat for the shortcomings of their own policies. But it is equally dangerous not to recognize the adjustment costs that globalization entails.

Moreover, says the BIS, managing globalization cannot be done just at national level; it requires robust multilateral governance. For lasting global prosperity, there is no alternative to the sometimes tiring and frustrating give-and-take of close international cooperation. (SUNS8494) □

The full BIS report can be found at: <http://www.bis.org/publ/arpdf/ar2017e.htm>

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Globalization risks need careful management, not backlash, says BIS

In the chapter on globalization released ahead of its full annual report, the BIS frowns on attempts to roll back globalization, saying they would be the wrong response to the challenges posed by tighter global economic integration.

by Chakravarthi Raghavan

GENEVA: Increased economic globalization has contributed to a remarkable increase in living standards across the world, and while its adjustment costs and financial risks need careful management, they do not justify a backlash against globalization, according to the Bank for International Settlements (BIS).

In Chapter VI of its 87th Annual Report, released for publication on 18 June, the BIS says: "Tighter global economic integration has been hugely beneficial. Globalization has been instrumental in raising living standards and has helped lift large parts of the world population out of poverty. Trade openness has greatly enhanced productive efficiency and vastly improved consumption opportunities. Financial openness, in addition to supporting international trade, allows greater scope for diversifying risks and earning higher returns. It also makes funding more readily available and facilitates the transfer of knowledge and know-how across countries."

Preserving benefits of globalization

In a foreword released along with Chapter VI, Jaime Caruana, General Manager of the BIS, says: "Arguments that question the benefits of globalization have been receiving greater attention in the public debate. This shows that we risk forgetting the lessons of the past and taking for granted the gains in living standards, productivity and prosperity achieved over the last half-century."

"In this year's Annual Report, we recommend taking advantage of the current tailwinds to growth to build economic resilience as a basis for sustained growth. Preserving the benefits of globalization is a key element of this strategy ... The focus we are putting on this issue reflects the importance of maintaining and developing these links and the changing nature of the debate about the global economy."

"Critics often blame globalization for the rising inequality in some indus-

trialized countries. Empirical studies show that other factors, mainly technology, have played a bigger role. It is true that the burden of adjustment often weighs heavily on specific sectors or regions. But sound domestic policies can help those who are negatively affected overcome these obstacles.

"Another criticism is that financial openness makes economies more vulnerable to ebbs and flows in global finance, and allows spillovers from one country to another. We should recognize that the global financial system is subject to procyclicality and excesses, just as domestic financial systems are. But the right answer is not to roll back financial openness. Rather, it is to put in place the necessary safeguards, just as the policy community has done in response to domestic financial liberalization.

"This will allow us to reap the benefits while addressing the challenges involved. The role of global currencies such as the US dollar, and of globally active banks, calls for close international cooperation in this regard. Indeed, as we show in the chapter, real globalization entails financial globalization – the two are inseparable, in that it is not possible to reap the benefits of trade and investment without international finance. One can think of globalization as consisting of three layers.

"That real and financial globalization go hand in hand is obvious in the first layer, where cross-border payments and credit are needed to facilitate trade of commodities and finished goods. But it is also true for the second, which involves more complex international trade. Financial openness allows the financing of cross-border investments and whole global value chains that distribute production across countries. It also allows hedging of the corresponding financial risks. It is only in the third layer that financial links are established solely for financial purposes.

"The analysis in the special chapter we release today should serve as a re-

minder of how globalization has boosted economic welfare. Instead of retreating from the ties of global trade and finance, we should reinforce them. Instead of loosening them, we should make them more resilient. We must work together to create well designed policies, both domestically and internationally. Only then can we make sure that globalization will continue to lift economic growth and living standards around the world for generations to come."

Worried

The BIS normally releases its entire annual report on the day of its annual meeting, which this year was to be held on 25 June, but has this time around released Chapter VI of the report a week in advance of the meeting. The remaining chapters and data were due to be released on 25 June.

This unusual release of only Chapter VI, titled "Understanding globalization", and with its message reinforced by the BIS General Manager's foreword, suggests that the BIS and its constituent central banks are worried that in the current state of politics and public debates in the advanced economies, there will be concerted efforts by some governments to rein in and discipline financial institutions and put the brakes on financial globalization.

Restraining these efforts may, however, result in increasing public mistrust in governments, and in particular central banks, several of which appear to have conflated their duty to safeguard public interest with their actions to shore up the positions of banks and finance capital (at the expense of the taxpayer) since the 2008 Great Financial Crisis (GFC), rather than acting as regulators to punish those in charge of financial institutions who had misbehaved and indulged in financial shenanigans that brought the system to near-collapse.

The end result may be to unleash forces that may result in the second wave of globalization coming to an end just as the first did in the last century.

Globalization, the BIS report says, has had a profoundly positive impact on people's lives over the past half-century. Nevertheless, despite its substantial benefits, it has been blamed for many shortcomings in the modern economy and society. Indeed, globalization has faced more severe criticism than technological innovation and other secular trends that have potentially had even more pro-

found consequences.

Chapter VI outlines how increased economic globalization – tighter trade and financial integration – has contributed to a remarkable increase in living standards. “Adjustment costs and financial risks need to be carefully managed, but they do not justify a backlash against globalization.”

Trade and financial openness are deeply symbiotic. Trade integration not only relies on but generates financial linkages. Banks with international operations underpin trade financing and follow their customers into foreign markets. Trade denominated in a foreign currency can require hedging, with counterparties accumulating international positions. Firms may build capacity in a foreign country with an attractive skill or resource base in order to export from there. Managing the financial asset and liability positions built up through trade induces still deeper financial linkages, including international trade in financial services.

Tighter global economic integration has been hugely beneficial. Globalization has been instrumental in raising living standards and has helped lift large parts of the world population out of poverty. Trade openness has greatly enhanced productive efficiency and vastly improved consumption opportunities. Financial openness, in addition to supporting international trade, allows greater scope for diversifying risks and earning higher returns. It also makes funding more readily available and facilitates the transfer of knowledge and know-how across countries.

Globalization has also posed well-known challenges. Gains from trade have not been evenly distributed at the national level. Domestic policies have not always succeeded in addressing the concerns of those left behind. The requisite structural adjustment has taken longer, and been less complete, than expected.

Furthermore, unless properly managed, financial globalization can contribute to the risk of financial instability, much like domestic financial liberalization has. And, not least through financial instability, it can increase inequality.

But globalization has also often been made a scapegoat. For instance, there is ample evidence that globalization has not been responsible for the majority of the concurrent increase in within-country income inequality.

Attempts to roll back globalization, the BIS says, would be the wrong re-

sponse to these challenges. Globalization, like technological innovation, has been an integral part of economic development. As such, it should be properly governed and managed.

Countries can implement domestic policies that boost resilience. These include flexible labour and product markets (the boilerplate standard advice since the 1980s by tenured academics and economists at international institutions, none of whom advocate the application of such policies to their own employment) and policies that enhance adaptability, such as retraining programmes.

Close cross-country linkages imply that policies and actions of individual countries inevitably affect others. Hence, international cooperation must supplement domestic policies. In particular, a global regulatory framework should be the basis for a sound and resilient international financial system.

Trade and financial interconnectedness

In outlining the deep interconnectedness of trade and financial openness, the BIS report maps out the historical path of globalization – from the “first wave” leading up to World War I, through the “great reversal” of the interwar years, to the revival and surge in globalization post-World War II in the “second wave.”

Recent suggestions of “peak globalization” are misleading, the BIS says, and it goes on to review how the structure of trade and financial integration has evolved in the second wave: the impact of globalization on welfare, its contribution to the substantial growth in incomes and the dramatic decline in poverty as well as the risks to financial stability linked with financial openness.

In advancing this line of argument, the BIS report appears to be crossing swords with (or ignoring the views of) economists like Dani Rodrik, with his characterization of developments as “hyper-globalization” and mooted policy changes running contrary to the BIS advocacy of trade and financial integration of the global economy.

And in a 14 June post on the *New York Times* blog under the title “A finger exercise on hyper-globalization”, Nobel economics laureate Paul Krugman, discussing the surge in trade from around 1990 to the eve of the Great Recession, has argued that this was the result of an

even seemingly small decline in transport costs having a large effect on the location of production, since it drastically reduced the production cost advantage emerging markets needed to have. This led in turn to an even more disproportionate effect on the volume of trade, leading to a sharp increase in shipments of intermediate goods as well as final goods, a lot of “value chain” trade.

In Krugman’s view, this was what happened after 1990, partly because of containerization and partly because of trade liberalization in developing countries. “But it’s also looking more and more like a one-time thing,” he says.

International trade and financial openness, the BIS says, go hand-in-hand. Trade is facilitated by financial links, such as international payments and credit, and in turn results in financial links, such as the accumulation of international assets and liabilities. As a result, it is not surprising that countries that are more open to trade also tend to have higher financial openness.

It is not clear from the released chapter whether the BIS economists think that financial openness involves openness to trade.

The report views Europe as the most integrated financially. However, while within Europe trade is open, vis-a-vis the rest of the world, claims of the EU’s “openness” to trade is questionable. Its agricultural markets and trade, for example, are highly protected.

The relationship between real and financial openness, the BIS says, however, evolves with the degree of integration and development. Conceptually, it says, one can think of three globalization layers.

The first, most basic layer is trade of commodities and finished goods and the corresponding simple international financial links, such as cross-border payments. The second layer involves more complex trade and financial connections. It includes trade in intermediate goods and services associated with the efficiency-driven fragmentation of production across countries and the corresponding financing arrangements. The third layer concerns the financial transactions increasingly used to actively manage balance sheet positions. These positions include the stocks of assets and liabilities, and exposures more generally, created by the first two layers, as well as the allocation and diversification of savings, not necessarily related to trade. The third layer thus introduces some

decoupling between real and financial openness.

The links between trade and financial openness are most immediate in the first globalization layer. In the second globalization layer, international financial linkages support a greater degree of specialization in trade and production, notably in the trade of intermediate goods. The third globalization layer is characterized by intricate financial links established solely for financial purposes.

The three layers share some common elements. One is the use of global currencies. As the dominant global currency, the US dollar is used to denominate around half of trade, roughly half of global cross-border bank claims, more than 60% of central banks' foreign exchange assets, and features in 90% of foreign exchange transactions. Thus, the dollar plays a central role in determining global financial conditions.

Globally active financial institutions operate in many countries across multiple continents. Through their international presence and sophistication, they facilitate the global transfer of funding and financial risks. Balance sheets that are managed at a consolidated level create close international financial linkages.

Waves of globalization

The first globalization wave, which died out with World War I and the Great Depression, saw a substantial increase in both real and financial cross-border linkages. Its collapse was as remarkable as its build-up: the "great reversal" in the interwar period witnessed an almost complete unwinding.

The second globalization wave, starting after World War II, has far outstripped the first. Trade openness surged beyond its prewar peak as countries traded more, and more countries traded.

For the world as a whole, trade openness has doubled since 1960. Trade growth in the two decades up to the mid-2000s was particularly rapid: China and former communist countries re-entered global trade and the second globalization layer expanded quickly. The specialization through the division of production stages across national borders resulted in the unprecedented expansion of global value chains (GVCs).

Financial openness increased with trade openness in both waves, but its rise has been much more marked in the second. Available estimates, while highly imperfect, suggest that financial openness is more than triple its prewar peak.

The rapid expansion in financial openness from the mid-1990s has been concentrated in advanced economies.

Though the BIS has refrained from drawing any conclusions from this, it would suggest that perhaps the rapid expansion in financial openness in advanced economies accounts for the backlash against globalization in these economies.

GVCs have been a key driver of trade growth, especially in manufactured goods, facilitated by improvements in market access, transport and technology: with high- and low-skill tasks increasingly located in different countries, trade in intermediate goods and services now accounts for almost two-thirds of total global trade.

Emerging market economy (EME) participation in GVCs has increased dramatically. In 2014, EMEs were involved in half of GVC trade. The share of GVC trade between EMEs has more than doubled. China alone is now responsible for 19% of GVC trade, up from 7%. And in the process, intra-EME trade integration has increased at a faster rate than that of advanced economies, alongside EMEs' greater heft in the world economy.

Large transnational corporations (TNCs) dominate global trade. With operations in multiple countries, they often play a prominent role in GVCs. For example, in the United States around 90% of trade involves TNCs, and half is between related entities within a TNC. Despite the expansion in EME trade, TNCs remain more prevalent in advanced economies.

Just as TNCs play a key role in trade, large internationally active financial institutions increasingly dominate global finance, particularly in advanced economies.

Standard BoP (balance of payments)-based measures of financial openness tend to underestimate the degree of global interconnectedness, just as they do for the non-financial sector, where TNCs' subsidiaries produce for their local market.

For EMEs, overall financial openness has grown only slightly faster than trade openness, but the composition of external liabilities has changed substantially to support greater risk-sharing.

Easing

The rise in globalization has been in check since the 2007-09 GFC. International trade collapsed during the GFC and, despite a rapid rebound, has re-

mained relatively weak. In real terms, global trade has barely grown in line with global GDP. In nominal terms, trade appears even weaker, failing to keep up with GDP growth owing to the fall in the relative prices of traded goods and services, particularly commodities. The GFC also brought to a halt the rapid rise in standard BoP-based measures of financial openness.

The interaction of real and financial factors within the first two globalization layers in part explains the easing in both trade and financial openness. More generally, the pullback in trade and financial openness reflects a desire to reduce risk, most obviously by financial institutions, but also by non-financial companies, as seen in the decline in disruption-sensitive GVCs.

However, at least on the financial side, the apparent pause in globalization needs to be interpreted with caution.

First, conventional measures somewhat overstate the reduction in openness. Second, the pullback in finance has been limited to some types of flows. It has been concentrated in cross-border bank loans. However, the contraction in bank lending is not as severe when measured using alternative metrics of financial openness, based on the location of headquarters of economic units, or on nationality basis that consolidates the corresponding balance sheet.

BIS international banking statistics (IBS) indicate that this transnational component has been much more stable post-crisis. Furthermore, there is some evidence that EME banks, many of which are not captured by the IBS, have substantially increased their international presence through foreign offices. This trend is especially pronounced at the regional level.

Globalization, the BIS says, has greatly contributed to higher living standards worldwide and boosted income growth. Over the past three decades, it has been an important factor driving the large decline of the share of the world population living in significant poverty, and of income inequality across countries. For example, poverty has fallen markedly in China, where the development of export industries has been a key force behind the rapid growth of GDP and incomes.

Over the same period, the income gains have not been evenly spread. The biggest gains have accrued to the middle classes of fast-growing EMEs and the richest citizens of advanced economies. In contrast, the global upper middle class

has experienced little income growth.

This has seen within-country income inequality increase in advanced economies and even many EMEs. The share of income accruing to the top 1% of income earners has increased substantially since the mid-1980s. High inequality appears to be harmful to growth and has undermined public support for globalization.

There is strong empirical evidence that globalization is not the main cause of increased within-country income inequality; technology is.

(In discussing the benefits of trade and financial openness, the BIS report uses differing language for trade and finance. This suggests that benefits of trade openness are rooted in empirical evidence while there is a lack of adequate empirical evidence for the gains from financial openness, with the BIS using language such as “should”, “could”, “can” and the like. – *SUNS*)

Both trade and financial openness can be expected to increase the rate of economic growth. Overall, trade has been found to boost growth in many economies. Trade also directly benefits consumers, as they can choose from a greater variety of higher-quality products.

Financial openness *should* (emphasis added) also boost growth, by enabling a more efficient allocation of capital and facilitating the transfer of technology and know-how. Empirical work has not universally identified increases in income or growth from increased financial openness. It has also been suggested that the benefits from capital account deregulation may be less direct and take time to detect.

Last but not least, many of the existing empirical studies treat trade openness and financial openness as independent variables, thus implicitly assuming that trade integration could take place without financial integration. Yet, argues the BIS, trade and financial openness tend to go hand-in-hand.

While national income undoubtedly increases with trade, the gains are unevenly distributed – a general feature of economic dynamism. The winners and losers are unevenly distributed across skills, income levels and location. Trade between advanced economies and EMEs generally increases the return to advanced-economy skilled labour, which is relatively scarce globally. In contrast, the returns to unskilled labour in advanced

economies may well diminish because of the greater competition from the large pool of unskilled EME labour. Conversely, unskilled labour in EMEs *may* (emphasis added) benefit.

At the same time, trade also leads to relative price falls for goods disproportionately consumed by lower-income households, boosting their relative purchasing power. Given these offsetting effects, the net effect on inequality from trade openness is uncertain in economic models.

There are also opposing channels through which financial openness could affect income inequality, enhancing opportunities for income generation of low-income individuals. Indeed, there is evidence that greater access to (domestic) finance can increase incomes of the poor. Alternatively, if financial openness, and foreign direct investment (FDI) in particular, increases capital intensity and the returns to skill, the benefits could accrue to higher-income individuals or if domestic institutions are not strong enough to prevent special interest groups from capturing the associated gains.

Trade and financial openness can also increase inequality by favouring income from capital sources, reduce labour’s “pricing” power, putting downward pressure on wages, and constrain the feasibility of taxing capital, contributing to higher taxes on labour income.

In practice, the BIS says, trade and financial openness appear to have made only a fairly small contribution to the increase in income inequality. For financial globalization, this effect is likely to have been somewhat larger in low-income countries. While declining labour shares have been linked to globalization, the evidence indicates that it is not the only driver. Importantly, the impact of trade on inequality depends on obstacles to adjustment. These effects can be persistent if labour is immobile across regions and industries.

Financial instability

Globalization, the BIS concedes, can affect economic growth, poverty and inequality by its impact on financial stability. Financial crises can result in a permanent loss of income, have a devastating effect on poverty and increase inequality. Unfettered financial openness can contribute to financial instability unless sufficient safeguards are in place.

Highly mobile international capital can behave in a very procyclical manner, amplifying financial upswings and reversals. Foreign currency exposure, in particular in dollars, transmits tighter global financial conditions and exposes countries to foreign exchange losses. And close financial linkages between globally active financial institutions can spread financial stress, although they may also act as a buffer when problems have a domestic origin.

This global currency channel is especially powerful in the case of the US dollar, the dominant international currency. The outstanding stock of dollar-denominated credit to non-bank borrowers outside the United States, a key indicator of global liquidity conditions, stood at \$10.5 trillion as of end-2016. This outsize external role means that changes in the US monetary policy stance have a substantial influence on financial conditions elsewhere.

And since monetary policymakers, including those in control of major international currencies, are focussed on domestic conditions, they could unintentionally end up contributing to financial imbalances well beyond their national borders.

The globalization surge over the past half-century has brought many benefits to the world economy. Openness to trade has enhanced competition and spread technology, driving efficiency gains and aggregate productivity. The resulting stronger income growth has supported a remarkable decline in global poverty and cross-country income inequality.

Financial openness, properly managed, *can* (emphasis added) also independently enhance living standards through a more efficient allocation of capital and know-how transfers. (The BIS report chapter does not say whether in fact it does.)

While globalization increases living standards, the gains are not equally distributed.

The distributional implications of trade and financial openness need to be addressed to ensure fair outcomes within societies and continued support for growth-enhancing policies and economic frameworks, including global commerce. Other factors – most notably technology – have played a dominant role in the in-

(continued on page 16)

EU and Brazil oppose end to Green Box cotton payments

A proposal by four African cotton-producing countries to slash trade-distorting subsidies on the crop has met with opposition from the likes of the EU, Brazil and the US at the WTO.

by D. Ravi Kanth

GENEVA: The European Union and Brazil have opposed the elimination of a range of Green Box direct payments for cotton as demanded by the Cotton-4 (C-4) countries – Benin, Burkina Faso, Chad and Mali – in the unresolved Doha agriculture negotiations at the WTO.

The EU-Brazilian opposition would ensure that Green Box subsidies will not be touched despite their trade-distorting effect, trade envoys told the *South-North Development Monitor (SUNS)*.

In their sustained efforts to secure a meaningful outcome on cotton subsidies at the WTO's eleventh Ministerial Conference, which is to take place in Buenos Aires this December, the four West African cotton-dependent countries have put forward for the first time a range of proposals on cotton subsidies in the Doha agriculture negotiations.

They proposed that both Green Box direct payments on cotton as well as trade-distorting Amber Box (Aggregate Measurement of Support, AMS) subsidies must be tackled in one go.

At a meeting of trade envoys of select countries convened by the chair of the Doha agriculture negotiations, Ambassador Stephen Karau of Kenya, on 30 June, the C-4 countries circulated a proposal demanding the elimination of Green Box payments, which run into over \$10 billion, along with steep reduction commitments in the most trade-distorting Amber Box subsidies, based on the formula approach of the Doha revised draft agriculture modalities text of December 2008.

Though the proposal has not been circulated officially, participants who took part in the meeting said the C-4 countries had made these two proposals.

Firstly, the C-4 said, the developed countries must eliminate the Green Box payments. And secondly, those WTO members – both developed and developing – which undertook AMS commitments in the Uruguay Round must agree

to steep reduction commitments as per the formula approach in the revised draft modalities of December 2008.

The four West African countries also proposed that the developing countries without AMS commitments must agree to a 10% overall limit on their cotton support programmes in line with the *de minimis* disciplines.

China, according to the C-4 proposal, can only spend up to 8.5% of its *de minimis* support as per the commitments that China undertook in its 2001 protocol of accession to the WTO.

Opposition

Surprisingly, the proposal on the elimination of Green Box measures for cotton faced fierce opposition from the EU and Brazil.

Incidentally, Brazil – which had championed the cause of agriculture reform by forming the G20 group of developing countries on the eve of the WTO's Cancun Ministerial Conference in 2003 (as a counter to the EU and US closing ranks to ignore their own agricultural subsidies and try to pry open developing-country markets for their subsidized farm exports) – has now joined hands with the EU to draft a proposal on how to reduce domestic support subsidies.

At the 30 June meeting, the EU and Brazil opposed elimination of Green Box payments on the ground that reduction commitments involved only trade-distorting domestic support or AMS payments in the unfinished Doha agriculture negotiations.

The EU and Brazil, however, said they will support steep cuts in the AMS in line with what will be agreed for reducing the overall trade-distorting domestic support.

The United States opposed the proposal from the C-4 countries on the ground that India and China are exempt from any cuts.

The US said it will not accept the C-

4 proposal that will allow the developing countries which did not undertake AMS commitments to continue with their subsidies under the *de minimis* track, said a trade envoy who asked not to be quoted.

Brazil and Colombia said the C-4 proposal cannot be supported, arguing that it made a distinction between the developing countries with AMS commitments and those without AMS commitments.

The C-4 countries are now expected to come up with a revised proposal, the trade envoy said.

In their Cotonou Ministerial Declaration on Cotton issued on 5 May, trade ministers of the four West African countries had emphasized that the subsidy payments – Green and Amber Box measures – are distorting “prices on the world cotton market, thereby contributing to the impoverishment of millions of people in the cotton producing and exporting African and least-developed countries” (LDCs).

The trade ministers stressed “the crucial role of the cotton sector in achieving the Sustainable Development Goals (SDGs), notably as regards the fight against poverty and the contribution to food security in the cotton producing and exporting African countries and LDCs.”

They said: “Trade Ministers gave a clear and specific mandate for addressing the cotton issue at the WTO in the Ministerial Decision on Cotton adopted on 1 August 2004 in Geneva and on 22 December 2005 in Hong Kong, calling for the cotton issue to be addressed ‘ambitiously, expeditiously and specifically’.”

The trade ministers urged “WTO members granting domestic support that distorts the international market to strive for further progress in the work on cotton, with a view to achieving the objectives established for this vital issue.”

The four trade ministers said they were “deeply concerned with the international context, characterized by the resurgence of protectionism and the uncertainty surrounding the WTO ministerial trade negotiations in the lead up to the Eleventh WTO Ministerial meeting.”

However, the prospects for an outcome on cotton at Buenos Aires remain bleak unless the four countries wage a grim fight on a make-or-break footing at Buenos Aires, said several trade envoys. (SUNS8496) □

Progress on world hunger has reversed

The world is facing its worst food crisis in postwar times, says the UN Food and Agriculture Organization (FAO), as conflict and climate change raise hunger levels.

by Tharanga Yakupitiyage

NEW YORK: World hunger has increased, reversing years of progress, said a UN specialized agency.

During its biennial conference held in Rome, Italy, from 3-8 July, the Food and Agriculture Organization (FAO) noted that the world is facing its worst food crisis since World War II.

"I wish I could announce here today some good news regarding the global fight against hunger ... but, unfortunately, it is not the case," said FAO's Director-General Jose Graziano da Silva to member states at the opening of the meeting.

FAO has identified 19 countries facing severe food crises due to a combination of conflict and climate change including South Sudan, northeast Nigeria, Somalia and Yemen where nearly 20 million are affected.

Though South Sudan recently declared that it no longer has areas in famine, millions are still on the brink of starvation as violence and insecurity ensue.

In fact, almost 60% of hungry people around the world live in areas affected by conflicts and climate change.

With no relief to be seen, many turn to migration, contributing to the doubling of global displacement, said Graziano da Silva.

The concerning trends come just two years after adoption of the internationally agreed Sustainable Development Goals, which include targets to eradicate hunger by 2030.

"Strong political commitment to eradicate hunger is fundamental, but it is not enough. Hunger will only be defeated if countries translate their pledges into concrete action, especially at national and local levels," said Graziano da Silva.

Though peace is important to end these crises, the international community cannot wait for peace in order to take action, he added.

Italian Prime Minister Paolo Gentiloni similarly called for "renewed and extraordinary efforts" during a keynote address, particularly pointing to the influx of migrants into the European

Union (EU) country's shores.

Italy is one of the major destinations for migrants who embark on dangerous journeys across the Mediterranean Sea.

In the first six months of 2017, Italy has taken in over 82,000 migrants. In the past week alone, more than 10,000 migrants have been rescued from overcrowded, unstable boats by the country's coastguard.

Overwhelmed by the numbers, the country has threatened to close its ports to rescue ships unless other EU countries share responsibility and help take in mi-

grants.

However, responding to emergencies alone will not be sufficient.

"To save lives, we have to save their livelihoods. We cannot save people and put them in camps," said Graziano da Silva.

FAO has highlighted the importance of work around climate change mitigation and adaptation, sustainable agricultural production, migration, and support of conflict-affected rural livelihoods among its key priorities.

"There is no peace without sustainable development, and there is no sustainable development without peace. Vulnerable people, rural people cannot be left behind ... we have to build the conditions for them to thrive, for them to have hope, for them to exercise their human right to food," Graziano da Silva concluded. (IPS) □

Saving lives by investing in the poorest

Investing in the health of the poorest communities saves almost twice as many lives, according to a UN agency's analysis.

by Tharanga Yakupitiyage

NEW YORK: In a new report titled "Narrowing the Gaps: The Power of Investing in the Poorest Children", the UN Children's Fund (UNICEF) has found that increased access to health among poor communities saves more lives and is more cost-effective than in non-poor communities.

"It is critical to focus on the poorer populations, especially in terms of health and nutrition," Senior Advisor for UNICEF and the report's author Carlos Carrera told Inter Press Service (IPS).

Impoverished children are nearly twice as likely to die before reaching their fifth birthday than children growing up in better circumstances. A majority of these deaths are preventable, but lack of access to critical health services makes them all too common.

Health interventions

However, UNICEF has found that health gaps between poor and non-poor communities have narrowed in over 50 countries and that improved access to health interventions among poor communities has helped decrease child mor-

tality three times faster than among non-poor groups.

Since birth rates are higher among the poor, the reduction in the under-five mortality rate translates into 4.2 more lives saved for every million people.

In fact, over one million people, a majority of whom lived in poverty, were saved during the final year of the 51 countries studied.

Such life-saving health interventions include increased provision of basic medication, skilled birth attendance, full immunization programmes, and even free health services.

In Bangladesh, new policies including the establishment of free community clinics and targeted sanitation and hygiene interventions have helped decrease under-five mortality by almost 75%.

Carrera pointed to Sierra Leone as another successful example as it introduced services targeting the major killers of vulnerable children and women, including insecticide-treated nets to prevent malaria, birth attendance, and immunization.

Between 2000 and 2013, the West African nation achieved up to 25% in-

creases in some intervention coverages among the poor.

“By combining all of these different methods, they managed to improve coverage of all these high impact interventions in poor populations,” Carrera stated.

However, the 2014-15 Ebola virus outbreak in Sierra Leone potentially set back decades of progress in the country, and serves as a reminder of the need for sustained investment in community health systems.

Though it is more expensive to reach marginalized populations due to barriers such as distance and lack of roads or infrastructure, the benefits outweigh the costs, Carrera noted.

For every million dollars invested, the number of deaths averted is 1.8 times higher among the poor than the non-poor.

“It is more costly, we accept that, but it is so much more effective because of the higher burden of diseases and higher risk for the health of poor children and women that it saves many more lives,” Carrera told IPS.

As a result, he advised governments to utilize an equity approach to identify populations and causes of death in order to design targeted interventions to reach and include the most vulnerable.

“That will be the most efficient way to use their resources – not just the most equitable, but also the most efficient,” Carrera added.

He noted that this is the only way for governments to achieve the Sustainable Development Goals (SDGs).

The internationally adopted SDGs, whose motto is to “leave no one behind”, include targets to reduce preventable deaths of children and provide equitable access to quality and affordable healthcare services for all, especially those who have not been reached.

Unless progress on reducing child mortality accelerates, which can only be achieved with focus and additional investment in the poor, almost 70 million children will die from preventable causes by 2030.

“With so much at stake – and so many lives hanging in the balance – we cannot afford to ignore this new evidence,” UNICEF stated.

UNICEF’s study draws on data from 2003 to 2016 in 51 countries where around 80% of all newborn and under-five deaths occur. (IPS) ☐

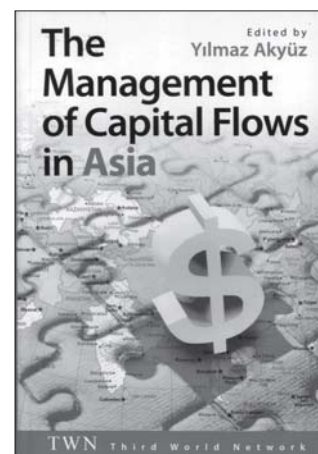
The Management of Capital Flows in Asia

Edited by *Yilmaz Akyüz*

THE 1997 Asian financial crisis brought home to the region’s economies the importance of managing capital flows in order to avert financial shocks. This book looks into whether and how this lesson was taken on board by policy makers in Asia, and, accordingly, how capital account regimes in the region evolved in the post-crisis period.

The early years of the new millennium saw a strong surge of capital flows into Asian emerging markets amid conditions of ample global liquidity. In response to the influx of funds, these countries generally chose to keep their capital accounts open to inflows, dealing with the attendant impacts by liberalizing resident outflows and accumulating foreign exchange reserves. While this approach enabled them to avoid unsustainable currency appreciations and external deficits, it did not prevent the emergence of asset, credit and investment bubbles and domestic market vulnerability to external financial shocks – as the events following the 2007 subprime crisis would prove.

This book – a compilation of papers written in 2008 for the first phase of a Third World Network research project on financial policies in Asia – examines the above developments in relation to the region in general and to four major Asian developing economies: China, India, Malaysia and Thailand.



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The Asian financial crisis – 20 years later

It was two decades ago that financial turmoil buffeted the hitherto high-flying East Asian economies. Much has happened since then, not least the eruption of a global financial crisis and the emergence of new vulnerabilities in emerging economies.

by Martin Khor

It's been 20 years since the Asian financial crisis struck in July 1997. Since then there has been an even bigger global financial crisis, centred in the United States starting in 2008. Will there be another crisis in the near future?

The Asian crisis began when speculators brought down the Thai baht, making fortunes in the process. Within months, the currencies of Indonesia, South Korea and Malaysia were also affected. The crisis was to turn the East Asian Miracle into an Asian Financial Nightmare.

Despite all the accolades showered on the East Asian emerging economies before the crisis, weaknesses had built up in the affected countries, including current account deficits, low foreign reserves and high external debt.

In particular, in a few years before the onset of the crisis, the countries had liberalized their financial system, in line with the international advice provided at that time. This enabled local private companies to freely borrow from abroad and in foreign currency, mainly US dollars.

Companies and banks in South Korea, Indonesia and Thailand had rapidly accumulated over \$100 billion of external loans in each country, prompted by these loans' lower interest rates compared with the local rates.

This was the Achilles heel that led their countries to crisis. These weaknesses made the situation ripe for hedge funds and other speculators to bet against the countries' currencies.

When the local currency devalued very significantly against the US dollar, and when governments spent their already low reserves in a vain attempt to stem the currency fall, three of the countries ran out of foreign exchange to service their external loans.

They went to the International Monetary Fund (IMF) for bailout loans that carried draconian conditions including

high interest rates, drastic cuts in government spending, no bailouts of failing banks and companies, whilst allowing continued freedom for capital to exit.

These IMF policies worsened their economic situation, leading to recession, job retrenchments and bank and corporate bankruptcies, besides the loss of economic sovereignty. Protestors in South Korea held signs reading "IMF equals I Am Fired!"

Malaysia was the fortunate country that did not have to seek IMF loans. The country's foreign reserves had gone to a dangerously low level but it was still adequate to finance imports and service foreign debt. If the ringgit domestic currency had been allowed to fall a bit further, the danger line would have been breached.

After a year of self-imposed austerity measures, Malaysia dramatically switched course and introduced a set of unorthodox policies. These included pegging the ringgit to the dollar, selective capital controls to prevent short-term funds from exiting, lowering interest rates, boosting bank loans, increasing government spending and rescuing failing companies and banks.

This was opposite to the prevailing economic orthodoxy and the IMF policies imposed on the other three countries, and the global establishment predicted the sure collapse of the Malaysian economy. But surprisingly the economy recovered, even faster and with less losses than the other countries. In fact the IMF had to relax some of its conditions on the other countries to avoid their performance being poorly compared with Malaysia's.

Today, the Malaysian measures (or some of them at least) are cited as examples of a successful anti-crisis strategy.

The IMF itself has changed, a little. For example, it now includes some capital controls as part of legitimate policy

measures in certain situations.

The Asian countries, vowing never to have to go to the IMF again, built up strong current account surpluses and foreign reserves to protect against bad years and keep off speculators. The economies recovered, but not back to the spectacular 7-10% pre-crisis growth rates.

Global crisis

In 2008, the global financial crisis erupted, with the United States as its epicentre. The tip of the iceberg was the collapse of Lehman Brothers and the massive loans given out to housebuyers that were not creditworthy, thus the term "sub-prime crisis".

The underlying cause was the deregulation of US finance and the freedom with which financial institutions could devise all kinds of shady "financial products" to draw in investors and unsuspecting customers. They made many billions of dollars with all the layers of financial intermediation and manipulative schemes, but with the Lehman collapse the house of cards came tumbling down.

To fight the crisis, the United States, under President Barack Obama, embarked first on expanding government spending. When that had its political limits, he relied on financial policies of near-zero interest rates and "quantitative easing", with the US Federal Reserve pumping trillions of dollars into the US banking system.

It was hoped that the easy availability of huge and cheap credit would get consumers and businesses to spend and lift the economy. But that only partly happened. Instead, a significant portion of the trillions went via investors into speculative activities, including abroad to emerging economies.

Europe, on the verge of recession, followed the US with near-zero (in some cases, below zero) interest rates and large quantitative easing, with limited positive results.

The US-Europe financial crisis affected Asian countries too, but only in a limited way. The main effect was on trade, with declines in export growth and commodity prices as demand fell in Western markets.

The large foreign reserves built up after the Asian crisis plus the current account surplus situation acted as buffers

against external debt problems and kept speculators at bay.

Just as important, hundreds of billions of dollars of funds annually poured from developed countries into emerging economies in Asia and other regions, in search of higher yield since interest rates in the originating countries were very low.

These massive capital inflows helped give a boost to the Asian countries' economic growth but have resulted in problems of their own.

First, they lead to asset bubbles, or rapid price increases of houses and the stock markets, and the bubbles may burst when they are over-ripe.

Second, the inflows may bring only short-term relief rather than being long-term solutions. Much of the funds are brought in by short-term portfolio investors looking for a quick profit, and they can be expected to leave when there is a change in conditions, such as a rise in interest rates in the US making that market more attractive.

Third, the countries receiving capital inflows have thus built up new vulnerabilities to financial volatility and economic instability. If and when investors pull some or a lot of their money out, there may be problems including price declines, inadequate replenishment of bonds, and decline in currency and foreign reserves. A few countries potentially face a new financial crisis.

A new vulnerability in many emerging economies is the rapid build-up of external debt in the form of bonds denominated in the local currency.

The Asian crisis two decades ago taught the lesson that over-borrowing in foreign currency like the US dollar is dangerous for a country as it may face difficulties in servicing the debt if the local currency falls; more money in local currency would then have to be forked out to repay the same amount of US-dollar debt.

To avoid this, many countries sold bonds denominated in the local currency to foreign investors, so that the repayment will be predictable and stable in terms of the local currency, thus avoiding the risk of a change in the exchange rate.

However, if the bonds held by foreigners are large in value, the country will still be vulnerable to the effects of a withdrawal when conditions change, such as a rise in US interest rates or a

crisis in a major emerging country that changes investor perception of emerging-market risk.

As an example, almost half of Malaysian government securities denominated in ringgit is held by foreigners, the result of the wave of capital inflows in recent years. Though the country does not face the risk of having to pay more in ringgit if there is a fall in the currency, it may still face difficulties if foreigners suddenly withdraw a lot of their bonds.

What is the state of the world economy and what are the chances of a new financial crisis?

Big and relevant questions to ponder over, 20 years after the start of the Asian crisis and nine years after the global crisis. But that is a subject for another article. (IPS) □

Martin Khor is the Executive Director of the South Centre, a think-tank for developing countries based in Geneva.

1997 Asian crisis lessons lost

Orthodox analysis has failed to draw the right lessons from the Asian financial crisis which broke out to such devastating effect 20 years ago, writes Jomo Kwame Sundaram.

After months of withstanding speculative attacks on its national currency, the Thai central bank let it "float" on 2 July 1997, allowing its exchange rate to drop suddenly.

Soon, currencies and stock markets throughout the region came under pressure as easily reversible short-term capital inflows took flight in herd-like fashion.

By mid-July 1997, the currencies of Indonesia, Malaysia and the Philippines had also fallen precipitously after being floated, with stock market price indices following suit.

Most other economies in East Asia were also under considerable pressure. In November 1997, despite South Korea's more industrialized economy, its currency also collapsed following withdrawal of official support.

Devaluation pressures also mounted due to the desire to maintain a competitive cost advantage against the devalued currencies of Southeast Asian exporters.

Blind spot

Mainstream or orthodox economists first attempted to explain the unexpected events from mid-1997 in terms of orthodox theories of currency crisis. Many made much of current account or fiscal deficits, real as well as imagined.

When the conventional wisdom clearly proved to be unconvincing, the "East Asian miracle" was turned on its head. Previously celebrated elements of the regional experience, e.g., government interventions and "social capital", were blamed for the crises. The media empha-

sized "cronyism", i.e., government favouritism for particular business interests, and poor corporate governance.

These were real problems, but irrelevant to explaining the crisis. Increasingly, blame was put on poor sequencing of financial liberalization, but not on capital account liberalization itself.

This blind spot has helped ensure that the most important lessons from the crisis have been largely lost. Other currency and financial crises from the 1990s make clear that key lessons have not been appreciated.

Instead, erroneous lessons drawn by orthodox economists, financial analysts and the media have muddled the policy discourse.

Also, the policies and policymakers responsible for the crisis need to be identified and addressed as they have come back, albeit in different guises.

Wrong lessons have diverted attention away from the intellectual and ideological bases of the erroneous thinking, analyses and policies responsible for the crises. Such ideas are largely though not exclusively associated with the "Washington Consensus" advocacy of economic liberalization at both national and global levels.

Thus, drawing critical lessons would undermine the intellectual, analytical and policy authority of the interests and institutions involved.

Finance rules

Although there was analytical work critical of East Asia's "miracle" before the crisis, none actually anticipated the de-

bacle or saw its roots in financial liberalization.

Meanwhile, transnational dominance of industry in Southeast Asia facilitated the ascendance and consolidation of financial interests and politically influential rentiers, later deemed “cronies” after 1997. This increasingly powerful alliance successfully promoted financial liberalization in the region, both externally and internally.

Southeast Asian financiers were quick to identify and capture rents from arbitrage and other opportunities offered by international financial integration. Little caution was urged in the face of greater foreign capital flows in Southeast Asia, which became more pronounced in the 1990s.

Washington Consensus policy advocacy of financial liberalization from the 1980s had uneven consequences and implications for the region.

This eventually led to new kinds of currency and financial crises due to easily reversed capital inflows, including foreign bank borrowings and portfolio capital flows.

As the interests of domestic financial capital did not fully coincide with those of international finance, the impact of financial globalization was partial and uneven.

For instance, both Malaysia and Thailand wanted capital inflows to finance current account deficits. This was largely due to their service account deficits, mainly for imported services and investment income payments abroad. Such deficits grew with imports for consumption and construction, as well as greater ease of investment, including speculation, abroad.

There is no evidence that such capital inflows contributed significantly to accelerating the growth of export earnings. Instead, they inflated asset price bubbles, which inevitably burst with devastating economic, social and political consequences.

Two decades later, there is apparently still no consensus on the East Asian crises and their causes. But contrary to the impression conveyed by the Western media, most serious analysts now agree that the crises essentially began as currency crises of a new type, different from those previously identified with current

account deficits, or fiscal profligacy, or even macroeconomic indiscipline more generally.

They also agree that the crises started off as currency crises and quickly became more generalized financial crises, before affecting the real economy. Reduced financial liquidity, inappropri-

ate official policy responses and ill-informed, herd-like market responses then exacerbated this chain of events. (IPS) □

Jomo Kwame Sundaram, a former economics professor and United Nations Assistant Secretary-General for Economic Development, received the Wassily Leontief Prize for Advancing the Frontiers of Economic Thought in 2007.

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crease in income inequality. Just as there is no suggestion to wind back technology, reversing globalization would be greatly detrimental to living standards.

Financial openness exposes economies to potentially destabilizing external forces, but this risk can be managed by designing appropriate safeguards. Since international trade and finance are inextricably intertwined, particularly in the first two globalization layers, reaping the benefits of trade would be impossible without international finance. That is why the policy solution is not to reduce financial openness, but rather to carefully address the associated risks, the BIS argues.

The challenges of managing economic change are not unique to globalization. As with other secular trends, well-designed policies can offset the adjustment costs associated with globalization and enhance the gains from it.

On the domestic front, countries can implement policies that boost resilience, including well-articulated macro-prudential frameworks on a firm micro-prudential base, and the capacity to address directly any debt overhang and asset quality problems that might arise during financial busts, in order to repair balance sheets and improve overall creditworthiness.

Indeed, EMEs have been taking important steps in this direction since the mid-1990s. And this has gone hand-in-hand with a better external balance sheet structure, helping to reduce their vulnerability to external factors, including through considerably stronger net international investment positions, substantial increases in their foreign exchange reserves and a higher FDI share.

International cooperation that addresses global linkages must supplement domestic policies. The special roles of

global financial institutions and global currencies transcend international trade and the financial interactions directly linked to it in the first two layers.

An internationally agreed joint regulatory approach is needed to ensure that policymakers properly manage global financial risks, not least those associated with the highly procyclical third layer. Because policies and actions of individual countries affect others, multilateralism is key for delivering the best outcomes for all.

The first priority for global financial institutions is to complete the international financial reforms already under way, which will go a long way to boosting the resilience of the global financial system.

An agreed global regulatory framework is the basis for effective supervision of internationally active banks, including mechanisms for cross-border information-sharing, and fostering a level playing field, a precondition for efficiency and soundness at the global level.

As regards global currencies, effective crisis management mechanisms remain important, and naturally require international cooperation. A greater emphasis on preventing the build-up of financial imbalances appears desirable. At a minimum, this would mean taking more systematic account of spillovers and spill-backs when setting policies.

International cooperation is also needed beyond finance to ensure a level playing field in trade and areas such as tax. Multilateral trade agreements provide the largest common markets to maximize efficiency.

Such well-designed domestic and international actions can ensure that globalization continues to be a greatly beneficial force for the world economy and people's living standards, the BIS concludes. (SUNS8485) □