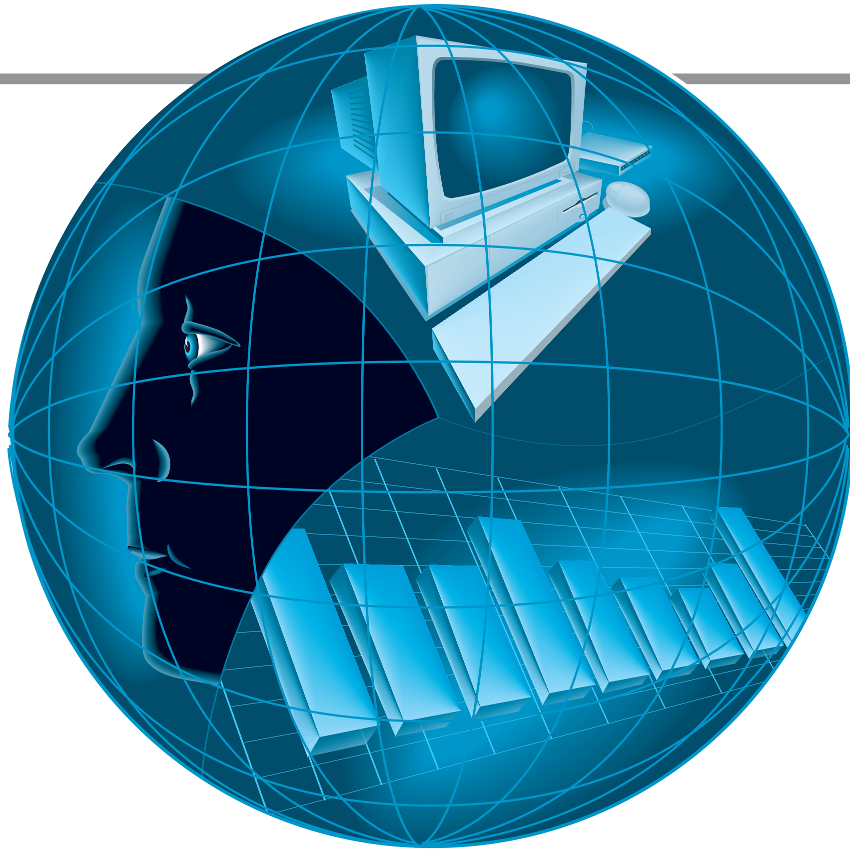

Globalization: New Opportunities, Tough Challenges

ZIA QURESHI

Greater integration of developing countries into the global economy will present some difficult challenges but is well worth pursuing. Industrial and developing countries alike stand to gain significantly.

OVER THE past two decades, world merchandise exports have roughly doubled as a proportion of world output, from 10 to 20 percent. With more and more services being transacted internationally, their share in world trade has risen from 15 to 22 percent. One in seven equity trades in today's world involves a foreigner as a counterparty. And, as the operations of multinational corporations have expanded, sales by their foreign affiliates may now well exceed total world exports. These statistics all point to globalization—the growing international integration of markets for goods, services, and capital.

Globalization is altering the world economic landscape in fundamental ways. It is driven by a widespread push toward the liberalization of trade and capital markets, increasing internationalization of corporate production and distribution strategies, and technological change that is rapidly dismantling barriers to the international tradability of goods and services and the mobility of capital.

While international economic integration has made major strides, its smooth progression is by no means assured. Protectionist pressures are bound to arise when change produces losers as well as winners and exacts adjustment as the price for its benefits, as international economic integration inevitably does. Pressures from industries and groups that will need to adjust to stronger international competition will continue to test the firmness of policymakers' commitment to more open markets, in both developing and industrial countries.

Rapid but uneven integration

Developing countries (including the transition economies) are a driving force in globalization. The share of trade (exports plus

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imports) in the GDP of developing countries has risen rapidly from about 33 percent in the mid-1980s to 43 percent today and could exceed 50 percent in the next decade (Chart 1). This acceleration marks a sharp break from past trends and reflects the adoption of outward-oriented reforms by a growing number of developing countries as well as the transition of the former centrally planned economies toward a market economy. In the seven years following the launching of the Uruguay Round negotiations in 1986, developing countries were responsible for 58 of the 72 autonomous liberalization actions reported to the General Agreement on Tariffs and Trade (GATT).

The increasing integration of developing countries in world trade is being accompanied—indeed reinforced—by their growing integration in world finance. Private capital flows to developing countries quadrupled between 1990 and 1994 (Chart 2). These flows now account for about three-fourths of all net long-term resource flows to developing countries. The flows have become more diversified than in the past, when bank loans dominated. Developing countries' share of world foreign direct investment inflows jumped from 23 percent in the mid-1980s to more than 40 percent in 1992–94. Private capital flows to developing countries have increased, in part because of improvements in these countries' policies and prospects. Structural changes in both source and recipient countries contributing to greater international capital market integration have also played a role—deregulation and liberalization of markets, asset diversification, and the internationalization of multinationals' operations.

While the developing world as a whole is becoming internationally more integrated, the level and pace of integration vary widely across countries. In trade, the contrast is most marked between East Asia and Africa. East Asia's integration in world trade has risen rapidly and in a sustained manner, whereas, in sub-Saharan Africa, the ratio of trade to GDP has been falling until recently and is still well below its level of twenty years ago (Chart 3). Trade integration of other regions—Latin America, South Asia, Europe, and Central Asia—has accelerated, but only relatively recently, with the shift toward outward-oriented reforms and the beginning of systemic transformation.

The financial integration of developing countries presents a similarly diverse picture. About 90 percent of private capital flows to developing countries in 1991–94 was concentrated in a dozen countries, mostly middle-income countries in East Asia and Latin America, with the exception of two large low-income countries—China and India (Chart 4). For most low-income countries, official flows remain dominant. But with the latter declining, recipients need to accelerate reforms that will enable them to attract more private capital.

Opportunities and challenges

Globalization has profound implications for developing countries. It creates important new opportunities—wider markets for trade, an expanding array of tradables, larger private capital inflows, improved access to technology. The outward-oriented reforms being adopted by more and more developing countries make the latter both agents and beneficiaries of globalization—these reforms both contribute to globalization and expand opportunities for developing countries to participate in its benefits. By promoting efficiency and productivity and providing a friendlier environment for exports and foreign investment, outward-oriented reforms have been key to recent improvements in the developing countries' economic prospects.

". . . the increasing integration of developing countries into the global economy represents a major—perhaps the most important—opportunity for raising the welfare of both developing and industrial countries over the long term."

The new opportunities are accompanied by tough new challenges of economic management. Integration requires adopting and maintaining a liberal trade and investment regime. In trade, competition is increasingly stiff, and the rapidly changing possibilities for trade favor the more agile. In finance, international capital market integration, and the potential volatility of capital flows that comes with it, are making macroeconomic management in developing countries more complex. Policymakers are confronted more and more with a new discipline—the need to maintain the confidence of markets, both domestic, and, increasingly, international. In this setting, sound economic policies command a rising premium; the payoffs are larger, but so are the penalties for policy inaction or errors. What is more, globalization increases competition between policy regimes; with greater capital mobility, investors increasingly are exploring opportunities worldwide and assessing a country's policies not only in the absolute but also relative to those in other countries.

The growing international role of developing countries also means they will have a greater economic impact on industrial countries. For example, about one-fifth of industrial countries' exports went to developing countries in the late 1980s. Today, this share has risen to about one-fourth, and it appears likely to exceed one-third by the end of the next decade. In 1991–93, when most of the industrial world was mired in a recession, markets in developing countries absorbed about three-fourths of the increase in world exports, thus fueling growth in the industrial economies. Provided developing countries continue with policy improvements, their share in world output, in purchasing power parity terms, could rise from 43 percent today to more than 50 percent in the next decade.

A recent World Bank report, *Global Economic Prospects and the Developing Countries 1995*, argues that the increasing integration of developing countries into the global economy represents a major—perhaps the most important—opportunity for raising the welfare of both developing and industrial countries over the long term. But countries will need to rise to the challenge. Five points bear emphasis:

• *The global economic environment is favorable to continued integration of developing countries into the world economy. But lagging countries risk being left farther behind.*

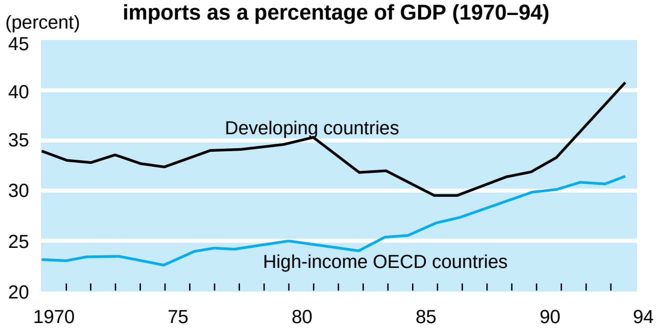
World trade grew by 9 percent in 1994 and is expected to rise more than 6 percent annually over the next ten years, almost twice as fast as world GDP. With trade acting as an engine of growth, the global economic outlook is conducive to further international integration of developing countries. These countries need to take advantage of this favorable outlook to deepen their outward-oriented reforms.

Successful integration of countries in the global economy will increasingly distinguish strong from weak economic performers. Countries best placed to benefit from the new opportunities offered by globalization are those that are rapidly transforming their policies and structures to support outward-oriented growth—adopting trade, investment,

Chart 1

Trade integration of developing countries has accelerated

Real merchandise exports plus imports as a percentage of GDP (1970–94)

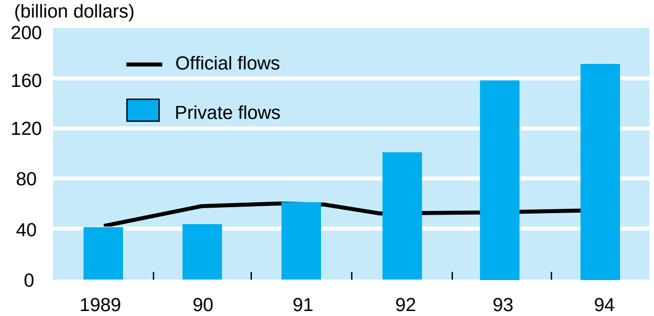


Source: World Bank, *Global Economic Prospects and the Developing Countries 1995* (Washington).

Chart 2

Private capital flows to developing countries have risen dramatically

(net flows, 1989–94)

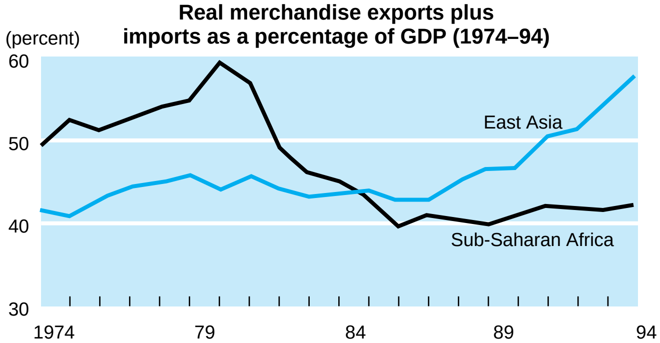


Source: World Bank, International Economics Department.

Chart 3

But progress on trade integration is uneven

Real merchandise exports plus imports as a percentage of GDP (1974–94)

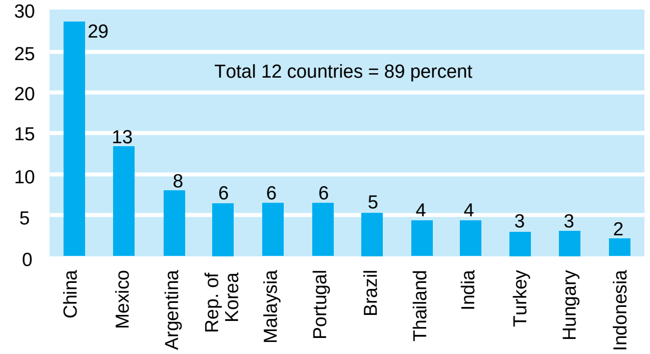


Source: World Bank, International Economics Department.

Chart 4

And private flows to the developing world are concentrated in a few countries

(percent of total flows, 1991–94)

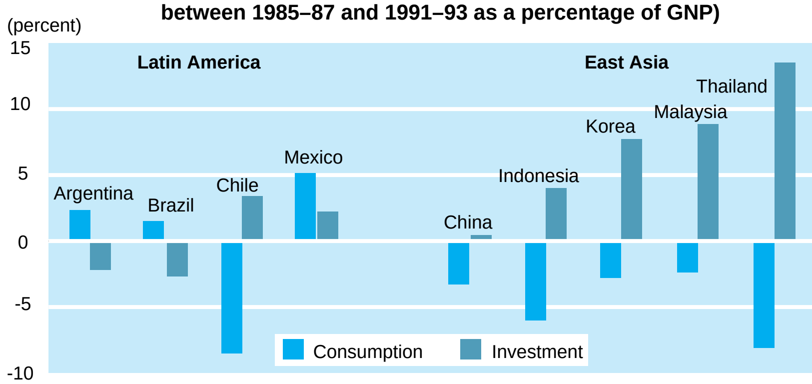


Source: World Bank, International Economics Department.

Chart 5

East Asia has channeled inflows into investment

(Change in consumption and investment between 1985–87 and 1991–93 as a percentage of GNP)



Source: World Bank, *Global Economic Prospects and the Developing Countries 1995* (Washington).

Note: The years 1985–87 represent the period before the inflows and 1991–93 the period after the inflows began to rise sharply. For the Republic of Korea, the average for the second period includes only 1991–92.

and exchange rate policies conducive to greater openness and competitiveness, and underpinning these reforms with a stable macroeconomic foundation. The dynamic East Asian economies provide the most notable example. Poor countries in sub-Saharan Africa and elsewhere are, in general, the least integrated internationally, and there is a risk that globalization may widen international disparities. Fast-integrating East Asia posted annual growth of 8 percent in the past ten years, whereas lagging sub-Saharan

Africa had annual growth of less than 2 percent. Finding ways to accelerate the international integration of lagging countries will be a special challenge. For economies that remain inward-looking, the risk of becoming marginalized is greater than ever; not only will the stream of new growth opportunities fed by surging international trade and investment continue to pass them by but, in a more integrated world, poor policies may increasingly be penalized by a flight of domestic resources.

• *The road to increased integration will not be smooth, as the crisis in Mexico shows.*

The increasing integration of developing countries in world capital markets brings major benefits but also requires stricter discipline in economic management since it leaves less room for policy errors. Mexico's crisis serves to underscore the critical role of sound policies in sustaining the confidence of financial markets. It also shows that, when a crisis of confidence develops, its impact can be sudden and damaging, with a spillover to other countries that market participants perceive as being in a similar situation. Given the speed at which capital can move in and out of countries today, policymakers need to pay particular attention to advance warning signals of looming problems.

Contrasts in East Asian and Latin American experiences in managing the rise in private capital flows in the 1990s are instructive. While individual countries in these regions have had different experiences, in general, East Asia has been more successful in attracting capital while maintaining economic stability and avoiding volatility in the flows. The region's greater success derives from its sounder macroeconomic policies, lower reliance on short-term inflows, and the channeling of inflows to more productive uses. Inflows into East Asia have tended to increase investment; by contrast, in several Latin American countries, they have fed increases in consumption (Chart 5).

• *The Uruguay Round agreement will boost international trade integration, but much remains to be done.*

Trade integration has received another shot in the arm with the successful conclusion of the Uruguay Round. The Round's achievements in improving market access and security are significant: a reduction of more than one-third, on average, in tariffs on manufactures; a significant scaling back, with the phaseout of the Multifiber Arrangement and voluntary export restraints, of nontariff barriers; extension of multilateral discipline to trade in agriculture and services; stronger and clearer rules, standards, and dispute settlement procedures; and strengthening of the trading system through the creation of the World Trade Organization. But a sizable agenda for reform remains in all these areas. It will be necessary both to implement the agreement firmly and to build on its achievements to keep international trade integration moving forward.

Gains from improved market access under the Round will be widespread but unevenly distributed. Countries' gains will depend more on their own trade policy actions than on those of others. Among developing countries, those offering significant liberalization, as in East Asia, will be the biggest gainers. Countries offering only minimal reform, as in sub-Saharan Africa, will enjoy only modest gains. Mere access to larger markets will not ensure desired gains. As markets become more open, it is increasingly the more efficient and competitive policy regimes that will win out.

• *The internationalization of services will likely lead the next stage of globalization.*

Not only is international trade buoyant, it is experiencing important structural shifts. Rapid advances in telecommunications and information technology are expanding the boundaries of tradability in services—the fastest-growing component of both trade and foreign direct investment. For developing countries, promising new avenues for exports are opening, especially in relatively labor-intensive long-distance services—data processing, software programming, clerical and professional services—that alone could potentially double these countries' commercial service exports, now valued at about $180 billion. The increasing tradability of services is enlarging the access of firms in developing countries to efficient, state-of-the-art producer services and a widening body of technical know-how through imports and foreign investment. The declining costs in telecommunications and information technology are opening up possibilities for developing countries to leapfrog stages of technological development.

To benefit from these opportunities, however, developing countries will need to improve efficiency in the provision of services. This is necessary not only to capture new export opportunities but also because access to efficient services will be increasingly important to competitiveness throughout the economy, reflecting the rising service intensity of production in general. Adopting a liberal trade and investment regime for services will be essential.

• *As developing countries become more integrated in the world economy, they benefit not just themselves but also industrial countries. But the process of integration will not be without friction.*

Contrary to populist rhetoric, the growth of developing countries and their increasing integration into world trade and finance benefit rather than hurt industrial countries. Specialization and efficiency gains to industrial countries from trade integration with developing countries are large—indeed larger than those from greater integration among themselves, since price differences between developing and industrial countries are, on average, about twice those between industrial countries. In services especially, costs in developing countries are typically a small fraction of those in industrial countries. Industrial countries also stand to gain significantly from the dynamic effects of trade integration arising from the spur to investment, innovation, and productivity growth provided by increased market size, competition, and technology spillovers. In finance, emerging markets provide an outlet that may offer higher returns as well as risk diversification for industrial country savings. The gains from trade and investment integration with developing countries are likely to increase over time because these countries are expected to grow nearly twice as fast as industrial countries.

Increased integration with developing countries will not be without adjustment costs for industrial countries, especially for their labor-intensive industries and low-skill workers. But, economywide and over time, these costs will be far outweighed by the gains from integration. Trade with developing countries will spur other industries and services in industrial countries where the latter will retain comparative advantage. But the reallocation of resources that this structural change entails is not easily accomplished and will inevitably generate frictions. There is a real risk that protectionist pressures could intensify. A successful transition will depend heavily on the efficacy of the policies of industrial countries in mitigating the social costs of adjustment and facilitating the reallocation of resources through the creation of more flexible labor and product markets. Successfully managing this process of integration will perhaps be the most important economic challenge of the future. Protectionist pressures to slow or reverse integration must be resisted, since that would make both industrial and developing countries lose—and lose dearly. F&D

This article is based on a World Bank report, Global Economic Prospects and the Developing Countries 1995 *(Washington).*