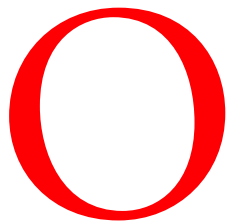


# Improving the International Architecture for Integration



ONE OF THE DISTINCTIVE FEATURES OF THE current wave of globalization is that many developing countries are participating actively—more than they did in the past. This greater participation comes partly from unilateral moves toward more open trade and investment policies.

But developing countries are also playing a more active role in the multilateral institutions that govern international trade and investment. This chapter focuses on the prospects for growing trade, investment, and labor integration between rich and poor countries, and how the international architecture can be improved to support that integration.

The first section focuses on trade policies. The Uruguay Round was quite different from earlier multilateral negotiations in the number of agreements that required developing countries to develop or upgrade their trade-related institutions. Developing countries made a “grand bargain,” in which they further lowered tariffs on manufactured products and adopted standards for Intellectual Property Rights (IPRs) in exchange for the abolition of rich country quotas on textiles and clothing, the introduction of more effective disciplines on agriculture, and abolition of Voluntary Export Restraints (VERs). Developing countries have been disappointed that the rich countries have been slow to follow through on their commitments to dismantle textile quotas and to reduce agricultural protection. A conservative estimate of the cost to poor countries of rich country protection is \$100 billion per year, about twice the total volume of foreign aid they receive. Developing countries also maintain significant trade barriers—70 percent of the tariff barriers that developing countries face are in other developing countries. There would be large gains from a round of trade negotiations focused on market access in goods and services.

Experiences with international capital flows are taken up in the following section. Hand-in-hand with trade liberalization, developing countries have reduced restrictions on foreign investment. Private capital flows to developing countries—especially FDI—have soared. FDI both increases the supply of capital and provides access to technology. While private flows have risen dramatically, official development assistance from industrial countries to developing ones has declined. For poor areas that do not now benefit much from globalization, there is a need for more aid, better managed. There has also been a more erratic increase in private financial flows—bank lending, bonds, and equity. These flows bring risks. We consider how the international community can better manage them. The process of opening up increases risks and has all too frequently been accompanied by devastating financial and exchange rate crises, although if countries can get through this stage their risk falls back to what it was before opening. Countries that are not yet fully open—such as China and India—should approach financial opening with caution. Good macro fundamentals and micro fundamentals (supervision and regulation of the financial system) are prerequisites to successful financial opening. Foreign investment in financial and accounting services can help with the needed strengthening. Even with the best of institutions and policies, countries can be buffeted by international financial crises because these markets are subject to irrational boom and bust cycles. Better international coordination is needed on accounting standards and transparency and on the management of incipient financial crises. This should be done in such a way that adequate liquidity is ensured for countries with sound policies, while at the same time private investors are discouraged from and penalized for risky lending practices.

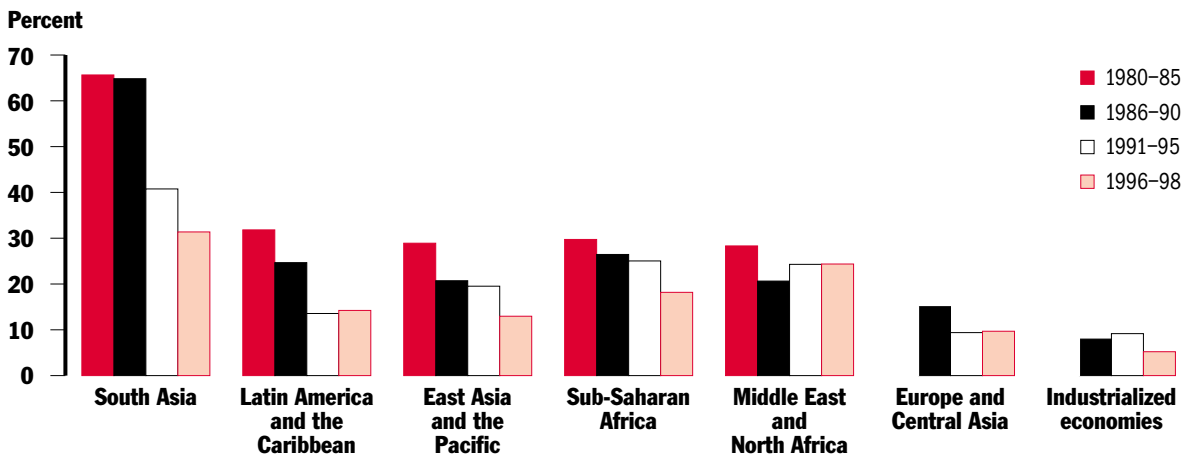
The final section focuses on migration from developing to industrial countries, and among the developing countries themselves. While migration could make a large contribution to poverty reduction, OECD immigration policies are highly restrictive and often encourage “brain drain” migration of highly skilled workers from the South, while shutting off legal flows of unskilled workers. It is understandable that migration is the most controversial of the flows arising from globalization. There is evidence that migration reduces the relative wages of unskilled workers in industrial countries, and also has effects on society and culture that some people value and others find threatening. Nevertheless, demographics will lead to growing pressure for migration of unskilled

workers. Most of the increase in the labor force in the next 15 years will occur in the regions where poverty is now concentrated: South Asia and Sub-Saharan Africa. In Europe and Japan, the labor force will shrink without greater migration, and the ratio of workers to retirees will rise sharply, putting extreme pressure on social security systems. There would be large mutual benefits from more migration of unskilled workers from locations with an oversupply of labor to those with an undersupply.

## Trade policy

**A**VERAGE TARIFF RATES IN DEVELOPING COUNTRIES HAVE BEEN cut in half, from around 30 percent in the early 1980s to about 15 percent in the late 1990s (figure 2.1). The absolute reductions in tariff rates in developing countries have been much higher than in industrial countries and decreases from a higher level are likely to have a much greater welfare benefit than corresponding decreases from a lower base (Martin 1997). In addition, the dispersion of tariff rates, which typically increases the welfare cost of any given average tariff rate, was substantially reduced. Reductions have been particularly large in South Asia, Latin America, and East Asia. Trade liberalization has been more limited in Sub-Saharan Africa and in the Middle East and North Africa.

**Figure 2.1 Average unweighted tariff rates by region**



Source: World Bank (2001d).

Along with these reductions in tariffs, the coverage of quotas fell sharply and foreign exchange restrictions were reduced, so that trade liberalization took place across a wide front.

The result of this trade liberalization in the developing world has been a large increase in both imports and exports. Developing countries in this more open environment are increasingly exporting labor-intensive manufactures. As recently as 1980 manufactured goods made up only a quarter of exports from developing countries. That share has increased steadily during the third wave of globalization, reaching more than 80 percent in 1998. Along with the changes in the commodity composition of exports have come substantial changes in the direction of exports. During the second wave less than 20 percent of developing country exports were destined for other developing countries. By 1995, this had increased to more than 40 percent. This increase in the importance of developing countries as markets for each others' goods results from a number of factors, including growth in the share of developing countries in the world economy and the liberalization of developing country trade. With 40 percent of their exports going to other developing countries, the barriers that these countries face from each other are clearly more important than they once were. More than 70 percent of the tariff burden faced by manufactured goods from developing countries is now imposed by other developing countries (Hertel and Martin 2001).

The dramatic increase in exports of manufactures from developing countries has contributed to protectionist concerns in both industrial and developing countries, and to the emergence of new concerns about such issues as labor standards. With so many developing nations emerging as important trading countries, reaching further agreements on multilateral trade liberalization has become more complicated.

The Uruguay Round ushered in a new era of multilateral trade negotiations (Martin and Winters 1996). For the first time, developing countries engaged comprehensively in the core business of the WTO, the exchange of market access concessions. Developing countries were willing to "bind" their tariffs on 100 percent of their agricultural imports and on more than 60 percent of their imports of industrial products (Abreu 1996).<sup>1</sup> Developing countries played a pivotal role in ensuring that agriculture was returned to GATT disciplines, that VERs were abolished, and that the highly protectionist quota regime for textiles and clothing would be phased out. To do this, they agreed to a "grand bargain," in which intellectual property protection of primary interest to the rich countries was introduced. The coverage of trade agreements

was also extended to services, and many disciplines that had previously applied only to members of plurilateral agreements were brought within the “single undertaking” of the Uruguay Round. The WTO was established and given a much stronger system for dispute resolution.

For developing countries, an important development that was perhaps not sufficiently noted at the time was the increase in requirements for deeper integration—that is, rules that require the strengthening of institutions to bring them into effect. This was most noticeable in the case of trade-related intellectual property (TRIPs), but also in areas such as the agreement on customs valuation. As Finger and Schuler (2001) have pointed out, the costs of implementing these agreements can be substantial.

Despite the dramatic increases in the size of the membership, and in the coverage of the multilateral system with formation of the WTO, relatively few changes were made in the operation of the trading system. The consensus principle is still used for major decisions, and all members are represented equally on the executive governing body, the general council, as well as at ministerial meetings. While this gives smaller developing countries much more representation than they would have with a smaller executive body, they have much less influence than the equality of representation would imply. Logistical difficulties mean that many developing countries are inadequately represented in Geneva, and hence unable to participate fully in the wide range of WTO activities (Blackhurst, Lyakurwa, and Oyejide 2001). Further, size matters in many cases, particularly in areas such as dispute settlement, where only larger countries can effectively threaten to retaliate against illegal measures. The power imbalance would be even worse if there was no WTO, because then small countries like Bangladesh would have to negotiate one-on-one with the United States without a multilateral set of rules. Still, it is important to keep in mind that developing countries have difficulty defending their legitimate interests in the WTO, and this difficulty is one reason why they generally oppose expanding the organization’s mandate to take up non-trade issues such as labor and environmental standards.

### **Improved market access**

The WTO has the potential to launch a “development round” of trade negotiations at its Doha ministerial meeting (see Hoekman and Martin 2001 and [www.worldbank.org/trade](http://www.worldbank.org/trade) for suggestions on what this might

include). A central objective of such a round should be improved market access for developing countries. There would be large mutual gains to improved access. We use a model to estimate these gains that is part of the Global Trade Analysis Project (GTAP). It provides a lower-bound estimate of the gains because its assumptions are deliberately conservative. First, it assumes that the developed countries have already fully honored their commitments under the Uruguay Round—notably the abolition of textile quotas. Second, it ignores benefits due to scale effects and dynamics. Third, it ignores benefits from the abolition of anti-dumping duties, “safeguards,” excessive standards barriers, and similar trade restrictions. Fourth, it ignores benefits from liberalization of trade in services. It is difficult to quantify the extent to which the model underestimates the likely benefits, but what has been left out may in fact yield even larger potential gains than what has been captured. With these limitations, the results provide some guidance as to what types of trade liberalization offer the largest gains to developing countries.

**Developing countries need better access to rich-country markets for manufactured goods.** Despite the substantial liberalization of developed country markets for manufactures, developing countries have most to gain from further liberalization of these markets. The model estimates presented in table 2.1 report an annual gain to developing countries from unrestricted access to the developed country markets in textiles and clothing of \$9 billion. Recall that this already assumes that the textile quota restrictions have been completely lifted. The gain from unrestricted access to the developed country markets for other manufactures would be

**Table 2.1 Potential annual gains from improving market access in a new Development Round, 1995**

(US\$ billions)

Benefiting region	Liberalizing region	Textiles and clothing	Other manufactures	Agriculture and food	Other primary markets	Total
Developing countries	Rich	9.0	22.3	11.6	0.1	43.0
	Developing	3.6	27.6	31.4	2.5	65.1
	Total	12.6	49.9	43.0	2.6	108.1
Rich countries	Rich	-5.7	-8.1	110.5	0.0	96.7
	Developing	10.5	27.7	11.2	0.2	49.6
	Total	4.8	19.6	121.7	0.2	146.3
All countries	Rich	3.3	14.2	122.1	0.1	139.7
	Developing	14.1	55.3	42.6	2.7	114.7
	Total	17.4	69.5	164.7	2.8	254.4

Source: Anderson and others (2000).

\$22.3 billion. Thus, the rise of manufactured exports from developing countries has made this a priority issue for developing countries. It was not part of the built-in agenda from the Uruguay Round, and hence preparations for negotiations on manufactures have not yet commenced, but the issues involved in manufactures trade are, in many respects, much simpler than those involved in either agriculture or services.

**Developing countries need better access to rich-country markets for agricultural products.** The model estimates that the gains to developing countries from unrestricted access to the agricultural markets of developed countries and abolition of rich-country export subsidies would be \$11.6 billion per year. While the potential benefits are substantial, there are major controversies. The countries with high agricultural protection, mostly industrial countries in Europe and East Asia, find themselves aligned against a North-South coalition of agricultural exporting countries. There are major controversies about whether the goal is complete liberalization, including elimination of agricultural subsidies. Another major source of discord is whether non-trade concerns, frequently labeled *multifunctionality* by the protecting countries, should be allowed to affect protection levels. In addition, there are new agriculture-related controversies about biotechnology and whether imports could be restricted under the so-called precautionary principle in the absence of scientific evidence.

**Developing countries need better access to each others' markets.** When developing countries were locked into exporting only primary commodities they had relatively little potential for trade with each other. Now that their exports have diversified, there is massive scope for increased trade among them. Indeed, because developing countries tend to have tighter trade restrictions than developed countries, they have even more to gain from greater trade with each other than from greater trade with the developed countries. The model estimates that they would gain \$27.6 billion per year by opening their own markets for manufactures and \$31.4 billion by opening their own markets in agricultural produce.

### **Large global benefits from temporary movement of service providers**

The current round of services negotiations at the WTO offers a valuable opportunity to liberalize the temporary movement of individual service suppliers. Many developing countries could then “export” the significant labor component of construction, distribution, environmental, transport, and other services. If the movement is temporary, then we can

be fairly confident that both the host and home country will gain. For exporting countries, it is clear that both the financial and knowledge benefits would be greatest if service suppliers return home after a certain period abroad. And for importing countries, such temporary movement should create fewer social and political problems than immigration.

### **Negotiating a Development Round**

Despite the potential gains from further trade liberalization, the effort at the Seattle ministerial meeting to launch a new round of trade liberalization was a disaster. Basically, rich and poor countries were pursuing different agendas. The recent report of the U.N. High-Level Panel on Financing for Development argues that:

The Seattle WTO ministerial meeting failed to launch a new round, not because of the protests in the streets, but because the major trading powers lacked the political will to accommodate the interests of developing countries... In order for developing countries to have confidence in a new round, rich countries must deliver on commitments made in the past, such as accelerating the agricultural trade negotiations and phasing out quotas on textiles and clothing (p. 6).

If indeed the major obstacle to a "development round" was the lack of political will of developed countries, it might be imagined that this is because the developed countries would lose from liberalization. This is simply not the case. The model estimates that the developed countries would gain in absolute terms even more than developing countries from enhanced global market access. Developed countries would gain about \$50 billion from improved access in the markets of developing countries and nearly \$100 billion from improved access to each others' markets. The benefits from market access negotiations are addressed in more detail in the World Bank's *Global Economic Prospects 2002*.

In addition to the benefits from tariff reduction presented in table 2.1, developing countries could potentially gain from reductions in anti-dumping duties, safeguard measures, excessive standards barriers, and barriers to trade in services. The available estimates suggest that the benefits of liberalizing services are of the same order of magnitude as those for



goods, and those from anti-dumping, safeguards, and standards are likely also of the same magnitude. A conservative estimate of the total impact of industrial country barriers on developing countries is likely to be more than \$100 billion, rather than the \$43 billion given in table 2.1.

### **Implementation concerns**

Improved market access is not the only issue for a "development round". The implementation concerns of developing countries cover a number of issues, of which some of the more important are the slow pace of removal of quotas on textiles and clothing, anti-dumping measures in the industrial countries, and a desire by some countries to keep Trade-Related Investment Measures (TRIMs). In addition, there are concerns about the implementation of the TRIPs agreement, the Customs Valuation Agreement, and with the costs of meeting many product standards. These must be addressed before developing countries will feel comfortable engaging in a round, and many of them imply a need for significant reforms. We take them in turn.

Unfortunately, the rules on textiles and clothing were written in a way that allowed industrial countries to greatly delay the abolition of their quotas. Instead of specifying the progressive abolition of quotas, the rules specified the progressive integration of textiles and clothing under GATT disciplines. Industrial countries were allowed to choose the products to be integrated; almost without exception, they chose to begin by integrating the products in which developing countries do not have a comparative advantage. Developing countries that thought roughly half of their exports of textiles and clothing would be integrated by 2002 found that almost all would remain restricted until December 31, 2005—creating concerns about potential backsliding in the industrial countries.

The anti-dumping rules of the WTO make no economic sense and allow countries to restrict imports when there is no economic justification. Developing countries bear a disproportionate burden of these measures in both industrial country markets and other developing countries. While Japan is seriously burdened by anti-dumping actions, Finger, Ng, and Sonam (2000) show that some developing countries face 30 times as many anti-dumping actions per dollar of exports as does Japan. It is clear that some form of contingent protection is needed when countries find

themselves politically unable to maintain an open stance, but more efficient and transparent safeguard systems that do not involve the abuses of anti-dumping can be developed (Finger 1998).

Many developing countries have expressed concern about requirements in the Uruguay Round agreement to phase out their trade-related investment measures. While some such measures may have an economic justification in countervailing the anti-export bias of the trade regime, most are merely an inefficient means of subsidizing multinational enterprises. This issue does highlight the problems associated with the traditional GATT approach of allowing time for implementation without respect to a country's stage of development.

A number of Uruguay Round agreements, such as those on TRIPs, customs valuation, and product standards, require developing countries to establish new institutions or to greatly strengthen existing ones. Further, some of these agreements effectively codify the established practices of the industrial countries, rather than seeking approaches to deal with these problems in the context of the developing countries. Finger and Schuler (2001) conclude that the Customs Valuation Agreement does not address the problems faced by developing countries and may cause serious loss of customs revenue under the conditions prevailing in many developing countries—unless a great deal is done to modernize and strengthen the customs service. But such investments in institutions are very expensive, and any such investment must be evaluated in the context of the country's overall development program.

The TRIPs agreement has raised many concerns about its implications for the cost of essential drugs. While there is widespread appreciation in developing countries of the need for some form of intellectual property protection in the emerging knowledge economy, there are concerns that current rules might price many patented drugs and other vital patented goods out of the reach of poor people in developing countries. This issue has been highlighted by a recent court case against the South African government for, among other things, allowing parallel imports of drugs in an attempt to lower prices. There is considerable flexibility in the current WTO rules to allow differential pricing of drugs, but some reforms may be needed to deal with the concerns of smaller developing countries that are unable to produce drugs themselves. If more fundamental reforms are considered, Jean Lanjouw (2001) has offered an interesting proposal for how the intellectual property rights for pharmaceuticals could be altered to ensure that poor countries have access to critical drugs at the marginal cost of production (box 2.1).

### **Box 2.1 Altering intellectual property rights over pharmaceuticals to benefit poor countries**

JEAN LANJOUW (2001) PROPOSES AN INNOVATIVE way to amend the international system for Intellectual Property Rights (IPRs) for drugs that address global diseases. In her scheme, pharmaceutical innovators can choose to have IPRs in either rich country markets or poor country markets, but not both. So, in the case of the anti-viral drugs that fight HIV/AIDS, it would be in the interest of the pharmaceutical companies—who did the research and development primarily with rich country markets in mind—to choose patents for rich country markets. The technologies would then be freely available in developing countries, but producers there could not export cheap drugs back to the rich countries. Lanjouw's point is that this system would be a very minor disincentive to innovation because most of the potential rents are in rich country markets. As a result, poor countries would have access to cheap

drugs but the incentives for innovation worldwide would still be strong. The nice thing about this proposal is that it would not discourage pharmaceutical companies from R&D on global diseases for which the main market is in developing countries. Where there is little demand in OECD markets for an innovation, then IPRs in developing countries can be an important incentive for firms (based anywhere) to research and develop products addressing the problem. Lanjouw's regime illustrates that IPRs are important to stimulate innovation and that it is in the interests of developing countries to protect rights that will lead to more innovation on their problems. On the other hand, there is nothing in it for developing countries to protect IPRs on treatments for AIDS or cancers that are common in rich countries, because that research will go ahead anyway, based on returns in OECD markets.

### **Participation concerns**

If a new round is to be a true "development round", it must take into account the greatly changed nature of the trade agenda following the Uruguay Round and its implications for the participation of civil society. Before the Uruguay Round, GATT negotiations tended to be over relatively arcane issues of tariff policy. Typically, these negotiations were conducted by negotiators and bureaucrats without much discussion of the issues in civil society. This has all changed with the expansion of the numbers of countries participating in the negotiations and the deepening of the trade agenda to include behind-the-border issues such as regulation of trade in services and IPRs.

The broadening of participation by developing countries has created a participation problem for the smaller developing countries that remains serious. Even for those smaller developing countries that have a permanent mission in Geneva, the diversity and complexity of the issues makes it impossible to participate effectively on more than a small range of issues. Almost half the least developed countries are

not even represented in Geneva, making it impossible for them to participate fully.

Related to the participation problem is an “ownership” problem that results when outcomes of negotiations have not been sufficiently discussed and debated within countries for the countries to feel a commitment to implement them fully. Cooperation between researchers in developing countries through networks such as the African Economic Research Consortium and the Latin American Trade Network is strengthening the analytical basis for informed debate on the issues, but more is needed to build the necessary basis for wider understanding.

Given the substantial investments involved, developing countries need to formulate their trade policy objectives within their overall development programs. Much greater cooperation between ministries within developing countries, and between development agencies and the WTO at the international level, is needed. The Integrated Framework for Technical Assistance to the Least Developed Countries is an initial attempt to integrate trade and development partners in support of the least developed countries, and may provide a prototype for deepening such cooperation in the future.

A great deal also needs to be done to build the domestic institutions to support a "development round". For example, taking advantage of product standards requires institutions to conduct testing and certify the results. Administering TRIPs requires the development of patent offices and related institutions. Development of these institutions is costly and time consuming, unlike traditional tariff cutting, and requires a great deal of support from development partners.

### **Keeping at bay the new protectionist agenda**

There are various proposals to introduce new issues into negotiations. These proposals rightly generate concern among developing countries. In particular, they oppose the notion of using trade sanctions to impose labor and environmental standards. There is a real danger that these would turn into new protectionist tools. Improving labor standards and working conditions is at the heart of the development process and requires a legal framework and programs of the type discussed in Chapter 3 to be developed and expanded. Our assessment is that measures to support these positive programs offer a great deal more potential for improving labor standards than the use of punitive

sanctions—especially when the risk of protectionist capture of labor standards is taken into account.

The interaction between environmental and trade measures is a vital issue, and one where markets frequently fail. There is a strong case for international cooperation on these issues, particularly where they involve international spillovers. However, in most cases, they are best dealt with in international forums established for the purpose, or a potential multilateral environmental agency, rather than the WTO, whose focus is on trade reform. These issues are discussed in more depth in Chapter 4.

**Should there be global rules on investment?** There are potentially substantial gains from the negotiation of international rules on investment. Such rules might, for instance, address the subsidies paid to attract investors. Unbridled competition for investment frequently results in incentives that are excessively generous, and creates an environment in which the deepest pockets—almost by definition not those of developing countries—are successful in attracting investment. They might also help developing countries attract investment by reducing the perception of risk in developing countries, and hence lower the cost of attracting investment. Such negotiations might be pursued either under the rubric of a special agreement on investment, or by building on the framework developed under GATS for trade in services undertaken by establishment within a market (Mode 3 of GATS). Whatever the approach, it is vitally important that the issue be approached in a transparent way, with maximum participation, and on the basis of a common understanding of the issues. Perhaps the primary lesson of the abortive Multilateral Agreement on Investment (MAI) negotiations at the OECD is that negotiations on such issues require widespread participation and discussion.

**Should there be global rules on competition?** Competition policy issues also warrant careful consideration. Smaller developing countries, with their smaller markets, are more vulnerable to a lack of competition than the rich countries. While many of these problems are domestic, and amenable to purely domestic policy solutions, others are beyond the scope of domestic reforms. In shipping, for example, Fink, Mattoo, and Neagu (2001) estimate that shipping costs are inflated by an average of 25 percent by the anti-competitive practices of international liner shipping firms. While the larger rich countries could deal with this problem unilaterally, smaller developing countries are not likely to be able to do so, and Fink, Mattoo, and Neagu recommend that stronger disciplines on restrictive business practices be developed in the current round of services trade negotiations at the WTO. However, care must be taken

that competition law reflects national concerns, priorities, and institutional capacities (World Bank forthcoming).

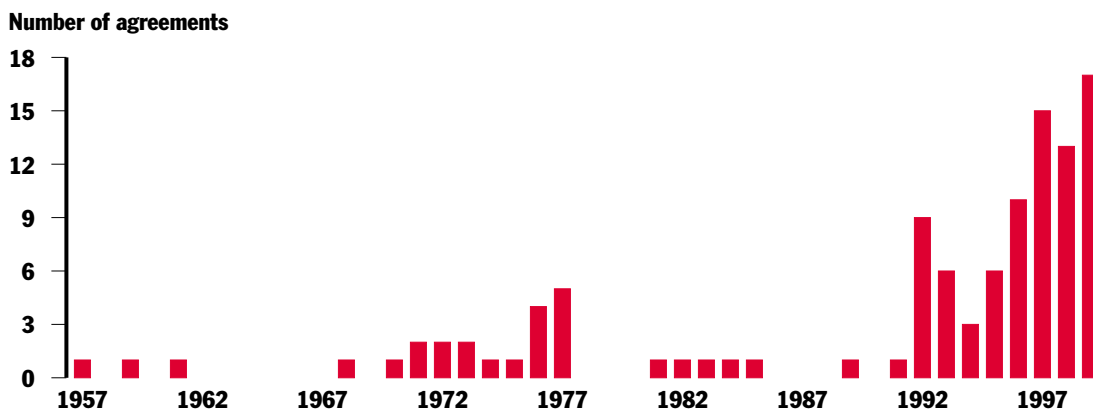
### Regional blocs

A final concern involves regional trade blocs. The regional approach to international engagement frequently appears attractive for two reasons: because it provides preferential access to partner markets, and because it may be easier to make progress with a small number of partners than with the 140 members of the WTO. These perceptions, and the increasing length of multilateral negotiations, have contributed to the dramatic increase in the number of regional trade agreements during recent years (figure 2.2). However, the advantages of South-South trade blocs are typically much less substantial than they might at first appear. They risk divisive redistributions without generating many overall gains. The companion report, *Trade Blocs* (World Bank 2000b), discusses this in detail.

## Policies for capital flows to developing countries

AS DISCUSSED IN CHAPTER 1, CAPITAL FLOWS TO DEVELOPING countries have increased massively during third wave globalization, and have shifted from aid, which actually declined during

**Figure 2.2 World Trade Organization notifications of regional integration agreements**



Source: WTO data.

the 1990s, to private capital. This change has also affected the destination of capital flows. Private capital goes predominantly to large and middle-income globalizing economies. This makes targeting aid flows more critical. We first discuss how aid can be better targeted in order to complement private flows. The largest component of private flows has been FDI. We defer discussion of this until Chapter 3, where we focus on the domestic investment climate. Financial flows, though smaller, have been more controversial and problematic. We consider them later in this section.

### **Aid flows**

Low-income countries that reform have trouble attracting investment. Here aid can play a helpful complementary role in assisting countries that reform their policies in the hope of becoming new globalizers. Aid reinforces the favorable effect of good policies on investment. Thus, one of the reasons why aid raises growth in good policy environments is that it attracts investment. Conversely, Burnside and Dollar (2000) show that large volumes of aid going into a poor policy environment produce little in the way of measurable growth, poverty reduction, or improvements in social indicators.

The conclusion to be drawn is that reallocating aid could increase poverty reduction. Aid should be shifted toward the low-income reformers and away from both middle-income countries that are able to attract private flows and countries with such poor policies that aid is unlikely to be effective. While this may seem like commonsense advice, as recently as 1996 the world was not doing it (Collier and Dollar forthcoming a). The allocation of aid had little relationship to poverty and no relationship to the quality of economic institutions and policies. The authors estimate that the impact of aid on poverty reduction could be roughly doubled by better allocation toward poor countries and ones with reasonably sound policies. In the past five years there has been some significant improvement in the use of aid. The concessional resources managed by the World Bank go to low-income countries and, among these countries, are allocated toward ones with good economic governance. Some major bilateral donors have moved in the same direction. Together with this has come a shift away from detailed conditionality in which donor agencies try to dictate every aspect of policy—an approach that generally did not work.

Collier and Dollar (forthcoming b) apply this model of assistance to poverty reduction in Africa. They conclude that a better allocation of donor assistance could significantly increase poverty reduction there. Most importantly, the combination of African policy reform and generous, well-targeted aid could make a substantial dent in poverty. Their analysis highlights the need for greater volumes of aid, especially if large countries in Africa such as Ethiopia and Nigeria follow through on policy reform.

The targeting of aid to low-income countries with good policies will help currently marginalized countries that aim to participate more in the global economy. Aid can also be helpful to those countries that, for whatever reason, stay marginalized. But in view of the past record it must be carefully thought through.

One of the major problems for the many marginalized countries that are heavily dependent upon primary commodity exports is their exposure to severe negative terms of trade shocks. New research finds that aid would be highly effective in mitigating the growth-reducing effects of shocks if it was increased at such times (Collier and Dehn 2001). Again, while this seems a commonsense use of aid, in practice aid flows have not responded promptly to adverse terms-of-trade shocks. Streamlining the efficiency of aid delivery (eliminating tied aid and numerous conditionalities) would make it easier for donors to respond flexibly to shocks.

Aid can also be targeted to specific problems affecting marginalized areas. For example, much more could be done to fund research into treatment or prevention of malaria, tuberculosis, and AIDS. The United Nations has called on industrial countries to provide \$10 billion per year to fight health problems of poor countries, but so far they have pledged only \$1.3 billion. While rich country incomes have grown well during this third wave of globalization, their foreign aid has declined to the historically low level of 0.2 percent of national income.

Another important aid issue is debt relief. Many of the marginalized countries are burdened with heavy external debts. The HIPC initiative is aimed at relieving this debt burden. However, it is important that debt relief represent new resources from the rich countries and not come out of existing aid. In general, HIPC initiative countries receive large gross flows of aid, so that even after servicing their debts they have significant net inflows of official aid. If their debts are forgiven but the flow of aid is reduced by a commensurate amount, then nothing real will have happened. It is the combination of debt relief and continued high gross flows of aid that would actually give these countries more resources for education, health, and other services.



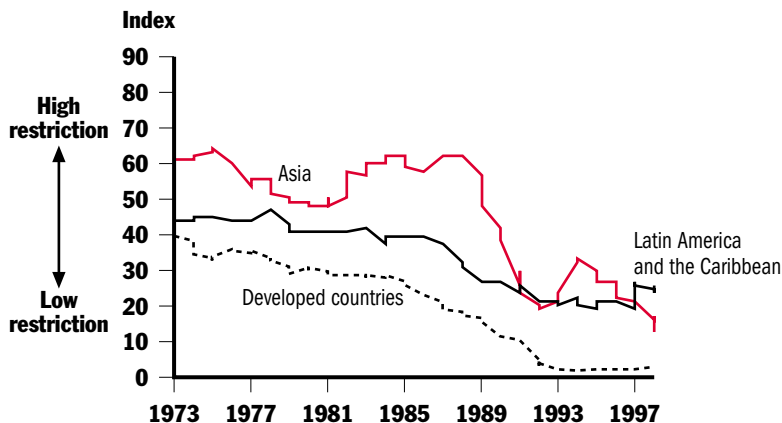
## Private financial flows

Third wave globalization has also been characterized by much greater involvement of developing countries in international financial flows. As Mundell (2000) argues, the 1970s witnessed the beginning of a new era in the international financial system. The oil shock provided international banks with fresh funds to invest in developing countries. Initially, these funds were used mainly to finance public debt in the form of syndicated loans. With the breakup of the Bretton Woods system of fixed exchange rates, countries were able to open up to greater capital mobility while keeping autonomy over their monetary policies.

The globalizing developing countries have gradually lifted their restrictions on capital account (figure 2.3). However, they have been partially re-introduced in the wake of crises, notably the Asian crisis of 1997.

As a result of these policy changes and technological advance, net private financial flows to developing economies have increased sharply since the 1970s. This greater supply of capital is a potential benefit of financial globalization. However, while financial globalization can bring benefits—especially for large and middle-income countries—it has also been associated in recent years with financial crises that carry devastating costs. Because of these crises, there is a perception that financially open countries experience more volatility. Surprisingly, the evidence suggests that *in the long run* volatility tends to decrease following liberalization and

**Figure 2.3 Restrictions on capital account**



Note: The data cover selected countries from the specified region.

Source: Schmukler and Zoido-Lobaton (2001).

integration with world markets, probably owing to diversification of asset portfolios and healthier development of the financial sector. However, the fact that open economies are less volatile in the long run is of little solace if the process of opening up temporarily increases the risk of a crisis. As a result, we would like to emphasize the distinction that *being open* financially is associated with greater stability, whereas *becoming open* financially is often associated with financial and exchange rate crises. Developing countries such as China and India that are relatively closed on their capital account should therefore approach liberalization very carefully.

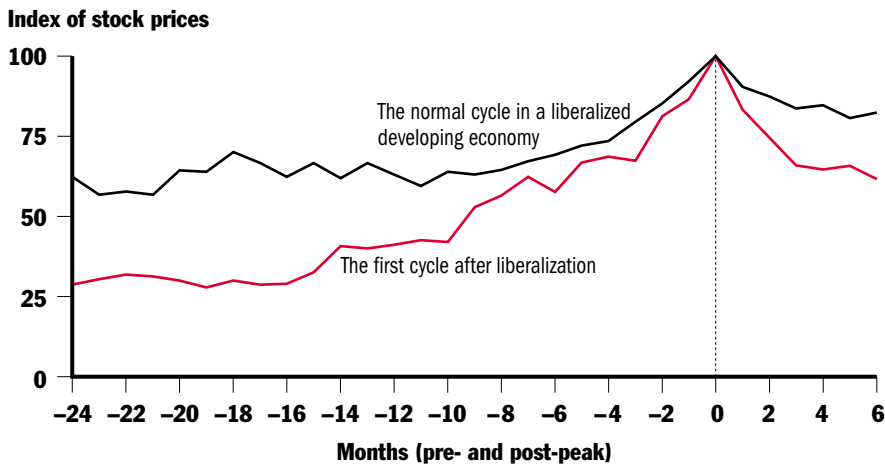
There is considerable debate as to whether financial crises are a greater problem today than in the past. Bordo, Eichengreen, Klingebiel, and Martinez-Peria (2001) study the frequency, duration, and impact on economic output of crises during the past 120 years. They compare the crises of third wave globalization with the two previous waves and with the retreat of the inter-war years. They conclude that crises are more frequent today than during the previous waves of globalization and are comparable to the inter-war years. There is little evidence that crises have grown longer or output losses have become larger. Bordo, Eichengreen, and Irwin (1999) compare today's wave of globalization with that of a century ago, taking into account the much greater degree of integration in today's global economy. They conclude it is surprising that financial instability is not worse. The authors conclude that the diminished risk of financial crisis can be attributed to the development of institutional innovations at both a global level and a local level (such as better accounting standards and contract enforcement).

What causes these crises and what can be done to mitigate the risks? The vast literature on financial crises stresses the importance of domestic factors as one key determinant of crises. Caprio and Klingebiel (1997), for example, stress the importance of both macroeconomic and microeconomic policies in determining banking crises. Similarly, Burnside, Eichenbaum, and Rebelo (forthcoming) argue that crises are determined not only by typical macroeconomic indicators such as actual deficits, but by other factors that generate large prospective deficits. A country's fiscal situation may look good on the surface, but a prospective deficit associated with implicit bailout guarantees to failing banks can help generate a crisis. In the countries affected by the Asian crisis, governments were actually running surpluses or negligible deficits, but had large implicit liabilities resulting from guarantees of deteriorating financial systems.

Thus, when countries first liberalize their financial sector, volatility and crises are more likely to arise if they have vulnerable fundamentals. Kaminsky and Schmukler (2001b) show that the process of opening up leads to a more extreme cycle in financial markets. In the typical stock market cycle of an open developing country, stock prices double during the 18 months before the cycle peaks, and then fall 20 percent over the first six months of the downturn (figure 2.4). For the first cycle within three years of financial liberalization, however, stock prices triple and then drop by 50 percent over the first six months of the downturn. Thus, a key question for developing countries is whether they have the robust financial institutions to manage this temporary volatility. If not, a serious crisis can ensue.

Second, crises can also be generated by errors in international financial markets. Financial markets can generate bubbles, irrational behavior, herding behavior, speculative attacks, and crashes. These can lead to crises even in countries with sound fundamentals. For example, if investors believe that the exchange rate is unsustainable they might speculate against the currency, which can lead to a self-fulfilling balance-of-payments crisis regardless of market fundamentals (Obstfeld 1986). Errors can also undermine fundamentals. For example, moral hazard can lead to over-borrowing when economies are liberalized and there are

**Figure 2.4 Liberalizing temporarily amplifies the boom-bust cycle**



Source: Kaminsky and Schmukler (2001b).

implicit government guarantees, increasing the likelihood of crises, as argued in McKinnon and Pill (1997).

Third, globalization can lead to crises due to the importance of external factors, even in countries with sound fundamentals and even in the absence of errors in international capital markets. If a country becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns. These shifts do not necessarily depend on a country's fundamentals. Calvo, Leiderman, and Reinhart (1996) argue that external factors are important determinants of capital flows to developing countries. In particular, they find that world interest rates were a significant determinant of capital inflows into Asia and Latin America during the 1990s. Frankel and Rose (1996) highlight the role that foreign interest rates play in determining the likelihood of financial crises in developing countries.

Contagion—the spreading of crisis from one country to another—can also be due to herding behavior. The magnitudes of recent swings in exchange rates and stock prices across countries seem to be beyond those predicted by any fundamental linkages. Shocks were indeed transmitted to economies where fundamental linkages are not present or strong, due to shifts in expectations. Herding leads investors to panic and flee countries that do not necessarily share fundamental linkages. The issue of herding behavior is one of multiple equilibria. If markets regard a country's state to be good, then large capital inflows can take place. If markets judge the country as being in a bad state, then rapid capital outflows and a crisis can occur. In a world of “multiple” equilibria, external shocks can quickly force the economy to shift from a “good” to a “bad” equilibrium. When investors suddenly become concerned about emerging markets for any reason, Wall Street reacts and European markets follow. When investors observe a crisis in Thailand, they react by thinking about a potential crisis in Indonesia and Malaysia, and a crisis indeed takes place. Both industrial and developing country markets are subject to these panics. Because investors know little about developing countries, they are probably more prone to herding behavior in these markets. Uninformed investors are the ones that find market changes more informative.

How can countries insulate themselves from these financial crises? We will emphasize four options that are not mutually exclusive: exchange rate management, supervision and regulation of the financial system, capital controls, and international crisis management.

The choice of exchange rate regime (floating, fixed, or somewhere in between) is a recurring question in international monetary economics.

It has become more important with the increasing integration of financial markets. All countries face the “impossible trinity”—that a country must choose two of the following three policies: fixed exchange rate, autonomous monetary policy, and free capital mobility. Pursuing all three leads to inconsistencies such that one of the three will be abandoned. After the crises of the 1990s it has become increasingly clear that countries with open capital accounts are being pushed toward “corner solutions”—either firmly fixing their exchange rate or following a flexible regime without pre-commitments. Which solution is best depends on the specific country and its circumstances.

By fixing the exchange rate, countries reduce transaction costs and exchange rate risk that can discourage trade and investment. At the same time, a fixed exchange rate has been used as a credible nominal anchor for monetary policy. On the other hand, a flexible exchange rate allows a country to pursue independent monetary policy responding to shocks through changes in the exchange rate and interest rate, to avoid going into recession. Under the combination of fixed exchange rates and complete integration of financial markets, monetary policy becomes powerless. Any fluctuations in the currency or currencies to which the country fixes its exchange rate will affect the domestic currency. Under a fixed exchange rate regime, other variables must do the adjustment.

Whether countries go with fixed or flexible rates, it is important to be firm about the choice if the capital account is open. The worst crises have occurred in countries that have managed their exchange rates to be relatively stable without a firm commitment to the fixed rate. In Thailand, for example, the long stability of the baht against the dollar encouraged firms and households to borrow in dollars to make domestic fixed investments—a highly risky situation susceptible to speculative attack.

A second important area for action is government regulation and supervision of the financial system. It is important to ensure that the financial sector is managing risk well. Government regulation and supervision should encourage financial institutions to avoid large mismatches between assets and liabilities, such as unhedged foreign exchange borrowings invested in non-tradable sectors and short-term assets used to finance long-term investments. These risky practices leave banks vulnerable to exchange rate depreciations and interest rate surges. Also, the regulation and supervision should ensure that banks are sufficiently capitalized with appropriate loan classification and adequate loan loss provisions. Transparency for investors and depositors through mandatory public disclosure of audited financial statements will help to enforce

market discipline. The removal of explicit or implicit government guarantees and sharing risk with investors will decrease the potential for moral hazard. *Finance for Growth* (World Bank 2001a) discusses in more detail the regulation of the financial sector in an integrated economy.

The recent experiences with crises and contagion highlight the importance of adequate risk management. Kawai, Newfarmer, and Schmukler (2001) argue that one of the more important lessons of the East Asian crisis is that highly leveraged and vulnerable corporate sectors were a key determinant of the depth of the crisis. Currency devaluations suddenly inflated the size of external debt (measured in terms of the domestic currency) and debt service obligations, thereby driving the domestic corporations into financial distress. High interest rates also sharply increased the corporations' domestic debt service obligations. These vulnerabilities affected the banks with exposures to the corporations. Krugman (1999) argues that company balance sheet problems may have a role in causing financial crises. Currency crises lead to an increase in foreign-denominated debt, which combined with declining sales and higher interest rates weakens the corporate sector and, in turn, the financial system.

Can financial liberalization take place without the appropriate risk management in place? This question leads to the issue of sequencing of liberalization. Having a robust financial sector is key for a successful globalization. But not all the conditions need to be in place before governments start to open up the financial sector. In particular, international financial services can help to strengthen the financial system so that it is better placed to integrate with world financial markets. It is difficult to achieve a very robust financial system while the country remains closed to foreign financial institutions.

A third policy issue concerns capital controls, which can be designed to reduce the probability or mitigate the effects of sudden shifts in foreign capital. Various proposals suggest that international capital flows should be restricted in very particular and judicious ways. Following the classification in Frankel (1999), the main proposals can be divided into several categories: (1) controls on outflows, which restrict investors to move capital outside the country; (2) controls on aggregate inflows, which are intended to keep capital from flowing into the country rather than restricting the exit of capital once it is in the country; (3) controls on short-term inflows, as were introduced in Chile, to avoid the build up of short-term debt; and (4) controls on foreign exchange transactions, or the so-called Tobin tax, aimed at imposing a small uniform tax on all foreign exchange transactions, regardless of their nature.

There is a very large literature on the effects of capital controls. On the whole, it finds mixed results. Probably the country whose capital controls have received the most attention is Chile, which imposed capital controls on short-term inflows through unremunerated reserve requirements. Chile was widely studied because it systematically put limits to capital flows in both episodes of international capital inflows to emerging markets (1978–81 and 1990–96). The evidence from studies including De Gregorio, Edwards, and Valdes (1998); Edwards (1999); Gallego, Hernández, and Schmidt-Hebbel (1999); and Soto (1997) suggests that controls on inflows introduce a wedge between domestic and foreign returns and allowed Chile's central bank to undertake a more independent monetary policy. This finding holds only when external shocks were small. Controls were not effective in preventing spillovers from very large shocks, such as the ones observed in the midst of the Asian crisis in 1997.

The experience with capital account controls in Asia has also been analyzed in various studies. The evidence for this region is also mixed. Reisen and Yéches (1993) examine the degree of monetary independence in Korea and Taiwan, China and find that capital mobility remained roughly constant in the 1980s in the presence of capital controls. However, these studies are concerned mostly with the degree of capital mobility in episodes of financial repression and do not compare these estimates with those in periods of financial liberalization. Analyzing the more recent experience in Malaysia, Kaplan and Rodrik (2001) argue that the Malaysian controls were able to segment financial markets and provided room for monetary and financial policies, allowing a speedier recovery from the crisis. They compare the recovery to what would have been possible with a more traditional response to the crisis. China is another interesting case, which apparently succeeded in remaining isolated from the recent crises although it could not avoid experiencing recent capital outflows.

The number of multicountry studies is much more limited due to the lack of comparable data on capital control measures across countries. Montiel and Reinhart (1999) construct a database for capital account restrictions of 15 emerging economies during the 1990s to study the effect of restrictions to capital inflows. They find that controls appear to alter the composition of capital flows in the direction usually intended by these measures, reducing the share of short-term and portfolio flows while increasing that of FDI. Another cross-country study with a new measure of capital account restrictions is that of Kaminsky and Schmukler (2001a), who find that controls work at best temporarily, with the effects diminishing over time.

Finally, as economies become more integrated, governments have fewer policy instruments and must rely more on international financial coordination. For example, bank regulation and supervision by one government is more difficult when liabilities and prices are denominated in foreign currency and when the banking sector is part of an international banking system. Also, in the midst of contagious crises, governments tend to lack sufficient resources to stop a currency attack and an individual government can do little to stop crises that originated in foreign countries. In these cases, international financial coordination can help individual governments achieve their goals.

Coordination is possible on a range of policies. One of the most important is the timely mobilization of external liquidity of sufficient magnitude to reverse market expectations in a context of sound policies. That liquidity usually comes from the international financial institutions, especially the International Monetary Fund (IMF). Given the magnitude of capital flows and the clustering of crises, isolated actions of individual governments or institutions are not sufficient to gain the required confidence. A coordinated action among governments and the international financial institutions is necessary to overcome crises and contagion, at both regional and global levels. To minimize potential moral hazard, it is necessary to involve the private sector so that private international investors share in the costs as penalty for excessive risk taking.

There is much that the world can do to improve the international financial architecture to prevent and manage financial crises in a systematic way. Current initiatives include setting international standards for transparency and dissemination of information, bank supervision and regulation, disclosure in securities markets, accounting and auditing rules, bankruptcy procedures, and corporate governance. New initiatives also include private sector involvement in financing packages to complement IMF resources and discourage moral hazard that could be associated with bailouts.

## Policies toward migration

**M**IGRATION CAN POTENTIALLY DO MUCH TO HELP REGIONS that do not now benefit greatly from globalization. However, while economic pressures for migration are strong and growing, legal migration is highly restricted. Compared to 100 years ago, the world is much less globalized when it comes to labor flows.

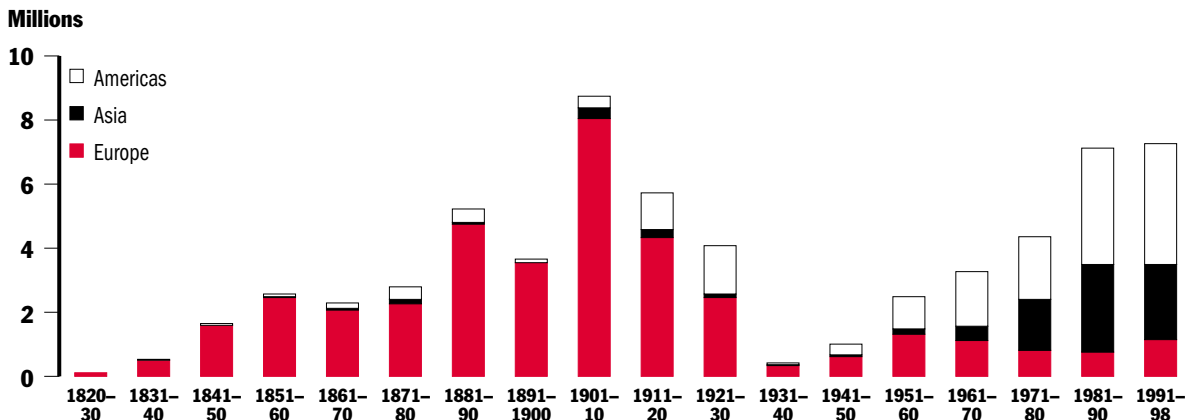


Let us look at the migration policies of a number of OECD countries, starting with the largest economy, the United States. The United States had an extremely open policy in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries, and large flows of immigrants, primarily from Europe. As a vast country with a lot of room to absorb newcomers, the United States also attracted capital flows throughout much of this period, which meant that high levels of migration went hand-in-hand with high and rising wages. However, by the time of the First World War and the early years afterwards, immigration had become a controversial subject in the United States. There was political mobilization against immigrants and a sharp shift in U.S. policy. The change in policy can be seen clearly in the sudden decline in the number of immigrants entering the country (figure 2.5).

After several decades of relatively restrictive migration, policies began to ease in the 1970s and especially the 1980s and led to an expanding volume of immigration. In contrast to the largely European immigration of the 1870–1910 wave, contemporary immigration into the United States comes largely from Latin America and Asia. As a result, the foreign population comprised 10 percent of the U.S. population in 1998 and a somewhat larger share of the labor force (reflecting the fact that most migrants move in order to work). If one adds in the estimated 5 million undocumented workers in the United States, then migrants make up about 12 percent of the U.S. population.

U.S. immigration policies are quite complex. Some migrants are allowed in to fill specific labor needs. Some of these shortages in the U.S.

**Figure 2.5 Immigrants to the United States by sending region, 1820–1998**



Source: Immigration and Naturalization Service (1998).

economy are in high-tech fields, leading to selective immigration of highly skilled engineers and medical professionals. But other shortages are in low-skilled areas (73 percent of all workers employed in crop production are immigrants), allowing immigration of unskilled workers from developing countries. Finally, U.S. law puts considerable weight on family connections. Now that there are sizeable numbers of Latin American and Asian emigrants who have settled in the United States, the family connections lead to immigration of a diverse group of people. The average immigrant into the country is less skilled than the average American, so that on balance migration brings the level of skills in the United States closer to the world average.

Migration is a controversial topic in rich countries, for both economic and social reasons. On the economic side, theory suggests that a large inflow of low-skilled workers from the South would put downward pressure on wages for those native workers without a high degree of education. A number of studies of individual U.S. cities find very small estimated effects of immigration on wages, but these studies are problematic because they treat the city as a closed economy that has an exogenous inflow of migrants. There is in fact a lot of city-to-city movement of Americans, which would render these estimates suspect. For example, if migrants are attracted to a particular location because of family connections and native workers then move away to other locations in response to downward pressure on wages, one would find similar wage trends in cities receiving immigrants and cities not receiving immigrants, but it would be incorrect to infer that immigration has no effect on wages.

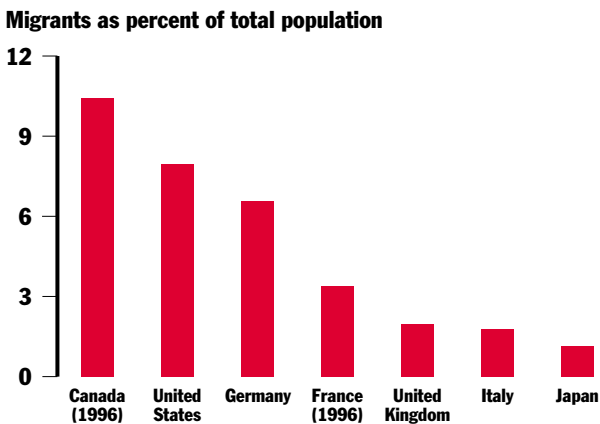
Borjas, Freeman, and Katz (1997) correct for this problem by looking at the nationwide effects of immigration. Their first finding of interest is that overall immigration increased the unskilled labor supply by 21 percent and the skilled labor supply by 4 percent between 1975 and 1995. So, despite some bias in U.S. law toward high-tech workers, the overall weight of U.S. immigration is tilted clearly toward unskilled workers. The second finding of interest is that the estimated effect of these labor supply changes was to decrease the relative wages of unskilled workers by 5 percent. That may not sound like a large number, but it was 44 percent of the widening wage gap between skilled and unskilled workers. The evidence is consistent with the view that technological change has shifted the relative demand for labor toward higher-skilled workers, so that even without immigration there would have been a decline in the relative earnings of unskilled workers. The inflow of a

large number of unskilled migrants at the same time pushed the relative wage down further and exacerbated mounting inequality.

From this, it is easy to see why immigration is controversial economically. An inflow of unskilled workers from the South will benefit highly skilled workers in the North. Their jobs are not threatened by these immigrants, and the presence of immigrants will lower prices for many things that the skilled workers consume (including food, restaurant and hotel services, and personal services—all areas of the economy in which unskilled workers tend to congregate). On the other hand, the same inflow will reduce real wages of unskilled northern workers from what they would be otherwise.

Immigration policies of OECD countries toward workers from developing countries vary substantially. One reflection of this is the variation in the share of legal immigrants from developing countries in OECD populations. For the G-7 countries, the share varies from about 10 percent in Canada to 8 percent in the United States, 6 percent in Germany, 3 percent in France, and 2 percent or less in the United Kingdom, Italy, and Japan (figure 2.6). In most of the rich countries, policies explicitly discriminate in favor of educated immigrants, encouraging so-called "brain drain" from the South. Recent Japanese economic plans, for example, note the policy of readily accepting foreigners possessing technological expertise but discouraging immigration of

**Figure 2.6** Developing country migrants relative to total population in the G-7 countries, 1998



Source: OECD (various years).

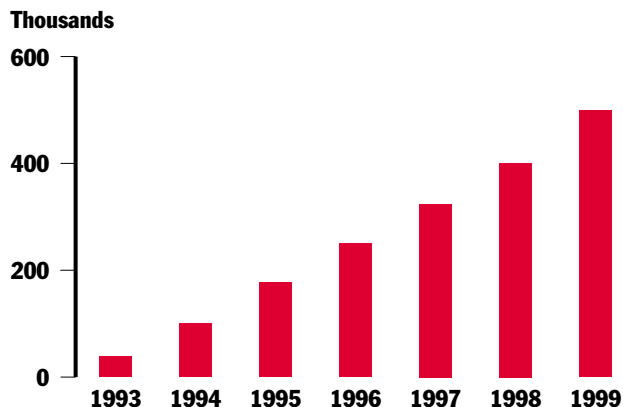
low-skilled workers. European policies generally aim to address labor shortages in high-tech and service industries.

Because immigration is very attractive economically and also highly restricted, there is naturally growing illegal immigration and trafficking in human beings. For the United States, there is an estimated net inflow of about 300,000 undocumented workers per year. But that figure is for the net increase in the stock of undocumented workers. Many more cross temporarily into the United States. In 1999 U.S. authorities apprehended 1.5 million illegal immigrants along the Mexican border. The great majority sent back to Mexico attempt to cross again within 24 hours.

Illegal migration into the EU has soared ten-fold in the 1990s, from an estimated 50,000 per year in 1993 to half a million in 1999 (figure 2.7). This illegal trade in people has become big business, with estimated revenues of \$10–12 billion per year. Smugglers charge as little as \$500 for a short hop across a single border (for example, Morocco to Spain). The price for a complex journey—for example, from East Asia to Western Europe—can go as high as \$70,000.

Illegal immigrants are vulnerable to exploitation. Bolivians trying to enter Argentina, for example, must carry at least \$1,500 (an attempt to distinguish tourists from undocumented workers). Not surprisingly, a new market has sprung up in which Bolivian migrants can borrow the \$1,500 for one hour to cross the border—for a fee of 10 percent (Stalker 2000).

**Figure 2.7** Illegal migration into the European Union, 1993–99

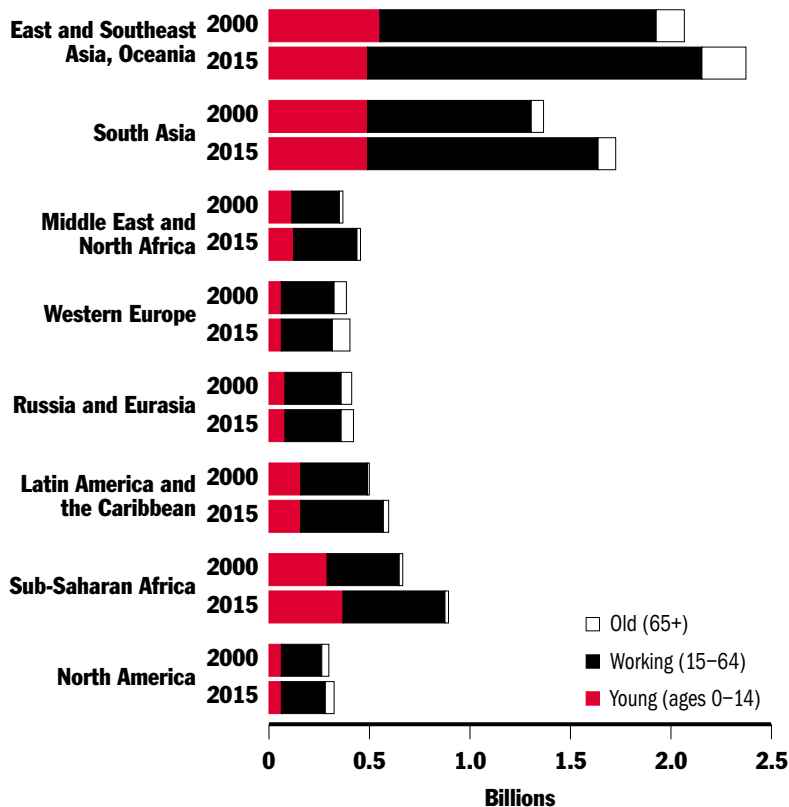


Source: International Center for Migration Policy Development data.

The pressures for migration of unskilled workers will become even stronger because of demographic factors. Each year, 83 million people are added to world population, 82 million of them in the developing world. Population pressures affect wages and hence migration, in the intuitive direction. Higher rates of population growth, other things equal, are associated with more out-migration.

Most of the increase in the working-age population in the next 15 years will occur in South Asia and Sub-Saharan Africa, the two regions in which poverty is currently concentrated (figure 2.8). At the same time, the working-age population in Western Europe and Japan will decline, given current birth rates and immigration policies. In Japan and the EU, the ratio of workers to retirees will decline from five to one today to three to one in 2015, without greater migration, putting a strain on social security systems. Potentially, there is mutual

**Figure 2.8 Regional population by age group, 2000 and 2015**



Source: U.S. Bureau of the Census data.

economic benefit in combining the capital and technology of the OECD economies with labor from developing countries. To some extent that can occur through flows of capital and production to developing countries. But we have emphasized above geographic factors that make it unlikely that capital flows and trade will eliminate the economic rationale for migration. Too many locations in the developing world have poor institutions and infrastructure that will not attract production, plus some of the existing production networks in the industrial countries are too deeply rooted to move (for example, Silicon Valley and its links to nearby universities). Institutional and policy reform and infrastructure investments in lagging developing countries could address the former concern and reduce, though not eliminate, economic pressures for migration.

Migration is the most under-researched of the global flows. As a result, we want to be cautious about drawing conclusions about the effect of migration. But it seems that out-migration can benefit developing countries, especially if migration policies stopped discriminating in favor of highly skilled workers, leading to the “brain drain” effect. Suppose that there were more freedom for both unskilled and skilled workers to migrate from South to North. The outflow of unskilled migrants would benefit sending countries by raising wages for those who remain behind and by generating a flow of remittances. The outflow of more skilled workers would also generate remittances and is likely to have spillover effects on trade and investment between sending and receiving countries. In the rich countries, this migration will reduce wages of unskilled workers from what they would be otherwise. But keep in mind that the demographic trends in rich countries will lead to rising relative wages for unskilled labor in the absence of more migration. Thus, there is good potential for increased flows of unskilled workers to the rich countries in an environment of stable relative wages.

## Summary of recommendations

**I**T IS IMPORTANT TO LAUNCH A NEW ROUND OF TRADE negotiations to maintain the momentum of global economic integration. Developing countries would benefit a lot from decreased protection in the rich world and from reducing their import tariffs and non-tariff barriers against each other. A “development round” of trade negotiations should focus on market access. Poor countries

have a good argument that labor and environmental standards cannot be improved through trade sanctions. More generally, developing countries should be given more scope and freedom to develop institutions that work for them, and trade agreements should refrain from imposing a single institutional model.

Concerning the international financial architecture, the frequency and depth of international financial crises can be reduced through better international coordination concerning transparency and information disclosure and crisis management. We support efforts to involve the private sector in crisis workouts to ensure that private lenders bear some of the cost of crises and so that private lenders have good incentives to avoid excessively risky lending. At the same time, international efforts, led by the IMF, to mobilize liquidity for countries with sound policies facing short-run shocks or contagion are critical for the smooth operation of the international financial system. Developing countries can do a lot to reduce the risks of crisis through good exchange rate management and supervision and regulation of the financial system. We support the move by many countries to use the international market for financial and accounting services to help strengthen domestic financial infrastructure. Foreign aid is critical as a financial flow to the poorest countries. Rich countries should increase their aid and target it to low-income countries with sound policies and to problems of poor areas such as health challenges, connectivity, and agricultural technologies.

Migration will also have to be part of the solution for the large number of people living in poor locations. Within large countries (China, India) or continents such as Africa, there will be growing pressure for people to move from poor rural areas to towns and cities. There is room in the world economy for more manufacturing/service agglomerations, and these are likely to appear along coasts or major rivers, provided that there is a good investment climate to attract production. There will also be mounting pressures for migration from south to north, especially of unskilled workers. Rich countries should avoid immigration policies that focus exclusively on “brain drain” migration of highly skilled workers from south to north. Such policy will continue to drive unskilled workers into illegal migration, which has increased dramatically in the 1990s. With the aging of populations in rich countries and the surge in population in the areas where poverty is currently concentrated (South Asia and Africa), more freedom for unskilled workers to migrate to the north could be mutually beneficial.

## Note

1. That is, to enter into a commitment not to increase their tariffs above a specified level recorded in a schedule of concessions at the WTO.