

# Some Factual Observations on the Interdependence between International Financial Flows and the World Trading System

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*The paper attempts to highlight the interdependence between international trade and finance in an ever unstable economic environment. An historical account is illustrative of the early resonance of the present problems. The main concern relates to the magnitude and volatility of financial flows which arguably obscure the real determinants of production and commerce.*

*The first part of analysis explores the origins of financial instability and provides explanations for its perceived economic impact. There are solid arguments that policy uncertainty has become a pervasive circumstance in the international economy. This fact not only casts doubts on the economic fundamentals, but also signals to the developing world a bleak prospect for future growth.*

*The second part sheds light on trade policy responses given the volatile context on the capital markets. The institutional effort, albeit significant, often seems ineffectual to come to terms with the virulence of financial crises in the world trading system.*

*The paper concludes that international coordination to mitigate the effects of global crises and pragmatism as a continuous process of responsiveness on behalf of the states could represent an appropriate reaction to instability and random economic difficulties.*

*Key words: World economy; international trade; financial instability; capital flows*

## **1. Introduction**

In spite of their obvious interdependence, the trade and financial flows seem to have been developed quite autonomously. The Bretton Woods arrangements agreed in 1945 just reinforced that historical fact, by imposing different institutional arrangements and approaches towards the world trade and financial systems.

This paper explores the various types of trade policy responses as they are induced by evolutions in international financial markets. While setting the perspective on the real side of the economy, that is commerce and production, most of the analysis explores two important issues arising from the monetary side: to what extent is the financial volatility, and the vulnerability associated with it, harmful to the economy?, and second, how

do governments respond to the challenges posed by the financial markets?

The findings are organized in the next four parts. Part 2 makes a brief foray into the historical evolution of the international financial system in relation with its interdependence with the growth of the real economy. Part 3 discusses the types of financial flows and the implications they have for the stability of the international exchanges. Part 4 brings in the likely trade policy responses to the challenges created by the modern capital flows. The final section summarizes and concludes with some remarks on the expected behavior of states, in terms of their commitment to the international trade system.

## **2. An historical glimpse.**

International financial flows have been permanently associated with the real flows of commerce and production. The more the latter needed to expand, for instance through investments, or to protect against the foreseeable risks, the more direct and effective the impact of this relationship could be perceived. It is a commonly accepted opinion among economists that "finance derives most of its value from the real business operations it makes possible" (Lessard, D, R, 1980). Before being inferred from any abstract calculation, this judgment was first perceived as a conspicuous part of every day business.

Until the middle of the last century, the ordinary firm normally operated in small localized markets, and only seldom ventured into remote and riskier areas. Such an uncertain environment, coupled with the beginning of the industrial revolution, which spurred product innovations and dynamic commercial exchanges, brought into relief the need of a properly developed financial infrastructure, so that firms would be able to make decisions within a larger geographic area and time horizon.

Confined temporarily to their small-scale and current transactional demands, firms relied mostly on the private banks' services of the issuance of short-term credits. The data available for the United States show an impressive increase in the number of banks over a short time interval, from approx. 300 by 1837, to more than 700 in 1920 (Besanko et al., 1996). An interesting detail of this evolution is given by the existence of important personal relationships underlying the process of credit granting (Besanko et al., 1996), a feature related to the insufficient development of the capital market. This remark may come as no surprise as finance, among other economic endeavors, affects in the most direct way the personal well-being.

Nonetheless, the subject needs more attention, as, on the one hand, it reveals the imperfect link between production and finance, in the sense that it is the market institutions, and not the market by itself, which finally regulate the economic flows. Brenda Spotton (1997) makes a thorough analysis on what she calls "the most important reason to understand the phenomenon of financial instability", that is, the institutional context within which it occurs. She refers, following Charles Kindleberger's investigation, to the American market crash of October 1929, when the revelation of the fraudulent activity of an influential person, Clarence Harry, admittedly was one of the causes which triggered the panic.

From a different perspective, the powerful financier John Pierpont Morgan, acting as if he would have been America's central banker, actually rescued the financial markets, both in 1895 and 1907, from an inevitable collapse. It is considered that never a private individual would play such a supervisory role in America's economy any more<sup>1</sup>.

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<sup>1</sup> See Hardy Green, *America's last emperor of finance, a review of "Morgan.American Financier"* by Jean

On the other hand, the "personal" factor proved to be an ingredient in the economic and financial system's development, and not just an episode. The industrial revolution effervescence just brought into attention the case of the credit needs for the small firms, but for centuries the big firms had acted in no other manner but making the private connections a rule to conduct their businesses<sup>2</sup>. Since the 1300s, the world trade developed by means of the several large firms' ability and prosperity. According to Neff (1990), they soon came to constitute "a transnational community of their own", and formed strong alliances with the states by attracting or simply requiring large amounts of money to finance their commercial expeditions.

In other instances, some countries, characterized by a fragile economic and political structure, had to act at the will of powerful private bankers. Neff (1990) refers to the case of Egypt, which in the 1870s, was practically ruled by Evelyn Baring, of Baring Brothers Bank, its creditor. The author mentions that a similar fate was also shared by other states, among which he includes Greece, Tunisia, Morocco, the Ottoman Empire and various small countries in the Caribbean and Central America.

The general, market-based demand for financial services would be far better met by the end of the 19<sup>th</sup> century, once the revolutionary energy also embraced transportation and communications, which shortened distance and made transactions more reliable and affordable. The new industries – steel, aluminum, automobiles, and chemicals – were based on mass-production and economies of scale, creating an economic pattern, which basically remained the same for the next 70 years. The

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*Strouse (Random House)*, in *Business Week*, April 19, 1999.

<sup>2</sup> Our remark bears no pejorative sense; it just aims at revealing the historical detail useful in our search to understand how monetary and real economies intertwine.

enlargement of manufacturing process and the expansion of commerce beyond the national borders resulted as a natural consequence.

Several advanced economies, as United Kingdom, France, Germany and United States, which together accounted for 78.4 % of the world exports in 1913 (Bairoch and Kozul-Wright, 1996), strengthened to a great extent the bilateral commercial links and gave rise to an unprecedented growth of international trade. The world trade as share of global production consequently reached a remarkable 33 % by 1913, compared to the present approx. 25 %, against only 3 % by the beginning of the century (Neff 1990, 217).

The financing needs of an ever expanding production and commerce commenced however to find an appropriate market response. The emergence of some important investments firms made possible both profitable administration of savings through placements in the productive sectors, and capital augmentation by underwriting most stock transactions. Financial innovations, as forward and futures contracts, had been introduced by the end of the 19<sup>th</sup> century for such assets as currencies, bonds, equities and commodities (Larson et al., 1998).

Some authors doubt that a more settled environment for investments would have been very much favorable to a prevalence of the private entrepreneurs. Rather, as documented by Joseph Schumpeter in his "Business Cycles" (1939), founding an institutional mechanism able to induce growth "often involved close collaboration between the state and financial and industrial interests" (quoted in Bairoch and Kozul-Wright, 1996). The argument could be also substantiated observing that the state administration had significant influence in investment domains critical to the new industries, as railways, utilities and public works.

At the same time, the network of international contacts of the great powers,

whether states or firms, channeled the domestic savings towards lucrative opportunities abroad, in their colonies, or in liaison with their commercial affairs. In a study on globalization, The Economist (1998) estimated that, by some measures – i.e., the ratio of trade to output, the current-account imbalance relative to GDP, the labor and capital mobility – the international economic integration was much more consolidated by the beginning of the century than nowadays.

Nevertheless, the expansion of the world economy brought about the possibility only of a world-wide economic growth. The financial and commercial flows actually caught up in the system mainly the developed regions, which were capable of managing a virtuous circle: industrialization – domestic and foreign capital formation – cumulative growth dynamic. Although the beneficiaries of the capital inflows were the less developed countries as well, the weaknesses of the economy vitiated the virtuous links, and, as the case of Latin America fully exemplifies it, amplified the financial and production crises.

The sour lesson of the 1929 crisis led domestically to a more regulated financial market, and internationally to a more restricted one. On the contrary, with the exception of the Second World War period, the principle of free trade was invariably promoted by states and firms alike. The Bretton Woods system has represented a very clear reaction of the international community to the nature of the link between financial and commercial flows. It inaugurated in fact a double faceted international system of liberalized world trade, with decreasing barriers to trade, and managed financial flows, with capital controls and fixed exchange rates.

The end of post-war reconstruction period in the 1970s meant also the collapse of the Bretton Woods system and the return gradually to the unhindered expansion of the financial flows. As presumed, the questions

about the consequences of the financial instability have surfaced anew.

### **3. Exploring financial instability**

There is little doubt that the present world economy has been experiencing an impressive dynamics of the financial flows [graph 1, Annex]. Although trade growth continues to outpace world GDP growth, and to remain in absolute terms, at approx. 7 trillion of dollars (including commercial services), the most important flow, it is accompanied by a superior evolution of the financial transfers it directly supports, whether as foreign direct investments (FDI), or as cross-borders mergers and acquisitions (M&A).

Nevertheless, what may appear as the most telling historical lesson is that the magnitude of the financial circulation is not explained wholly by the real sector's developments. Events like the stock market crash of October 1987 have puzzled the economists and made them doubt the validity of the theoretical fundamentals. "There is no good economic reason why the nation's corporate equity should have lost nearly a sixth of its value in less three hours", remarks Nichols (1993) referring to that event. The critics of the present financial architecture do not miss to point to the increased power of financial markets as the principal reason for causing economic havoc, as in the European currency crises of 1992 and 1993, Mexico in 1994-95 and South-East Asia in 1997 (The Economist, 1998a).

Two of the most troubling issues lying at the core of this debate are related, on the one hand, to the massive circulation of finances and, on the other hand, to the instability associated with it. Each of them will be examined in greater depth in the remaining of this part.

*The volume and structure of capital flows.* Before any further consideration, attention should be paid to figures reflecting an impressive financial activity throughout the

world. Although part of them should be taken cautiously, due primarily to questionable underlying estimates and loose terminology, they make up a valuable point in understanding the present financial developments.

With the exception of trade credits and current account transactions one can easily notice that as decision moves away from the real economy, the level of transactions proportionally follows an upward path.

Foreign direct investments (FDI) have generally been seen to respond more appropriately to the needs of the international firm to expand and strengthen the production worldwide. In the recent years, FDI flows continued their growth, setting a record in 1998 to about \$644 billion, against \$424 billion in 1997. Although the most part of it is still sustained by transnational corporations from developed countries, developing countries have begun to play a more important role, witnessing an increasing share in total FDI inflows from 26 percent in 1980 to 37 percent in 1997, and in total outflows from 3 percent in 1980 to 14 percent in 1997 (UNCTAD 1998).

The growth of transnational activity has brought about a basic reconsideration of firms' competitive strategies, visible through a speeding up of M&A process. Underpinned by the dynamics of several branches as banking, insurance, chemicals, pharmaceuticals and telecommunications, total M&A transactions worldwide amounted to some \$1.6 trillion in 1996, out of which \$277 billion represented cross-border M&As (UNCTAD 1998). The merger frenzy was so impetuous, that deals worth more than \$1 billion, so-called megadeals, accounted for about a half of global M&A transaction values in 1997, compared to one-quarter in 1995.

The fluidity of international financial flows is increased further by the four most important forms of capital: portfolio investment (involving equity and bonds), short- and long-term bank loans, and stock-market

exchanges. The payments associated with foreign trade pale beside the volume associated with these flows, which, according to even the general estimates, amounts *daily* to approx. 10% of the world's annual GDP (Eatwell and Taylor, 1998). Specifically, in international currency markets alone, it was estimated that some \$800 billion to \$1 trillion changes hands each day, far in excess of the \$20 billion to \$25 billion required to cover daily trade in goods and services (Korten, 1995).

Data to cover the annual global volume in these cases can be hardly found, due primarily to much dispersed statistics<sup>3</sup>. Portfolio investments roughly imply a volume similar to FDI and display the same upward trend throughout the 1990s, at least for developing countries (IMF, 1999). Yet, it is the underlying investment reason which divides them. FDI are designed mainly for long-run operations, and, generally, are hard to reverse. As a matter of basic reasoning, they take into account the economic and political environment of the host country, and assess strategically the regional production capacities.

As for the former, the potential for expanding productive and commercial activities plays a negligible role. Because of their sole belief upon the assessment given by the market, equity investments induce, besides useful economic signals, euphoria and speculative behavior. Trailing interest rate differentials and currency fluctuations often seem to overwhelm the reasonable market expectations. A Bank of Japan study found that of the trading on the Tokyo Foreign Exchange Market in 1992 nearly 80 percent

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<sup>3</sup> As Duncan, J, W, an economist and statistician with the Dun&Bradstreet Corp. in New York, legitimately remarked, "there is a need for transnational banking authorities and national central banks to undertake a careful review of the types of financial flows occurring inside and outside current measurement systems". (*The statistics corner: issues in foreign trade data*, in *International Trade Journal*, Spring 1998).

was speculative in nature, and only 20 percent was related to trade<sup>4</sup>.

Besides portfolio investments, short-term loans add a lot to the dynamics of the capital flows. They admittedly played the trigger factor behind the 1997 Asian turmoil<sup>5</sup>. In the 1990s, short-term foreign borrowing in the affected East Asian economies increased at impressive rates, ranging from 600%-800% for Thailand and Malaysia, to 140%-170% in Taiwan and Philippines (Moreno et al., 1998), and reached finally between 60% and 90% of total borrowings in these countries.

The previous part considered financial power a constant ingredient of the international relations. It is the capital flows' swiftness and the increasing innovative financial instruments which are instead regarded as the new challenges for businesses and governments alike. They confer a high degree of freedom to the international finance, easily proved by the sheer magnitude of "money-seeK-money" sort of transactions, and eventually by the unstable environment they determine.

*The origins of financial instability.* Financial instability is essentially described by the great volatility and high degree of reversals specific to several types of capital flows, namely, stock and commodity market operations, portfolio investments and short-term borrowings, as the most recent econometric studies certify (Drabek and Griffith-Jones, 1998).

In operational terms, market volatility is generated by short- or long-term swings in exchange rates and interest rates (Eatwell and Taylor, 1998)<sup>6</sup>, which in turn induce extremely variable capital movements. Ever bigger capital volumes result in ever bigger

threats and opportunities, which countries and firms increasingly have to live up to.

For this reason, market volatility reveals itself contradictory, depending on the circumstances. A strong financier, George Soros, was able to find enough wealth-generating sources when the sterling pound was under pressure in the 1980s, despite the shocking effects his very speculation provoked for the British monetary policy.

In other cases, one can not find the needed competence to withstand large currency fluctuations. For instance, the large swings in the real value of the dollar from an index of 100 in 1980, to 135 in 1985, down to 94 in 1990, and up again to 134 in 1998 were felt worse in the emerging countries which pegged their exchange rates to the dollar, as a confidence-building measure, comparing to those which let their currencies float.

In these latter circumstances, the ability to react was impeded by the heavy and sudden flows entering and leaving the country, which rendered ineffective the monetary policy instruments. Jeffrey Sachs, an outspoken critic of the present international financial architecture, remarked the inability of the five Asian countries - Indonesia, South Korea, Malaysia, the Philippines, and Thailand - to face up to the short-term loans by mid-1997, which amounted to approx. 150% of the liquid foreign exchange reserves in those countries, a situation which admittedly framed the onset of the 1997 Asian crisis.

The vulnerability to large reversals of capital flows can generate an unstable growth environment as well. The implication is all the more valid these days as the capital flows represent an ever higher proportion of the domestic economy (graph 2, Annex).

The magnitude of the reversal, i.e. the sum of inflows and outflows, exerts considerable control on crucial issues as the exchange rate policy, current account deficit financing, long-term investments. Lopez-Maja (1998) provides reversals estimates for several

<sup>4</sup> See the paper of Blaine, M, in the *Strategic Management Review*, 1996.

<sup>5</sup> Kuttner, R, *What sank Asia? Money sloshing around the world*, in *Business Week*, July 27, 1998.

<sup>6</sup> An econometric calculus may be found in: Kono and Schuknecht (1998).

developing countries, and points to the difficulty of accommodating in these new conditions. Thus, between 10% and 18% of GDP accounted in the last two decades for capital swings in countries like Venezuela, Thailand, Mexico, and Malaysia, figures which, by any standards, imply tremendous efforts from their part in order to cope with these unexpected financial imbalances. Bhagwati (1998) recalls that the income loss imposed by the oil price increases of 1971 and 1973 on OECD countries was of the order of 3% of GNP and was sufficient to unsettle these advanced countries' macroeconomics almost throughout the 1970s.

There are several reasons to conclude that these features of the present capital flows are to be experienced more pregnant. The emergence of capital flows from private sources at the expense of the official ones makes difficult searching for a coordinated solution in case of default. Feldstein (1999) compares the feeble total lending capacity of institutions such as the IMF, which has less than \$200 billion to be extended to the countries in need, to the mighty American banks which alone have more than \$5 trillion in outstanding loans and investments. And the diversity of the present financial players, ranging from mutual funds and hedge funds to corporations themselves, makes the opportunities to borrow ever more attractive and riskier.

In this respect, the recent Asian crisis may be regarded as a textbook case. Borrowing abroad in dollars at far lower interest rates than required at home, has led officials to take on far more foreign debt than they could assuredly handle. The currency appreciation become inevitable and happened suddenly, and so did the runs on the national currencies in the face of massive outflows of foreign exchanges rapidly leaving the country as a result.

The rapid capital fluctuations are further sustained by the diversity of financial instruments whose leverage is often hard to

estimate. The study of Raines and Leathers (1992) clearly delineates the pros and cons of innovations in the financial markets.

On the one side, they argue, the system becomes more vulnerable in the face of the product innovations, which have recently taken such forms as securitization, zero coupons, stock option futures, money market accounts, and interest rate swaps.

Also inherently to the market, it is the *process* innovations which brings consistency in the form of activities aiming at adding support to particular transactions. The creation of the Federal Reserve System in the midst of a chaotic financial development in the USA at the beginning of the 20th century or the development of the SWIFT system for international payments provides some examples for such stabilizing methods.

Obviously, against this background, the wave of global liberalization, which for the last two decades enfolded even the less prepared emerging countries, does nothing but sharpen the challenges to withstand the risk.

It is hard to find a study not blaming the poor supervision of capital flows or the feeble financial infrastructure for generating instability and determining mismanagement against short-term flows. For instance, both Moreno et al.(1998) and Drabek and Griffith-Jones (1998) found substantial evidence on inappropriate incentives for risky and imprudent lending in the East Asian countries, or ineffective institutional structures in the countries of Central and Eastern Europe, respectively.

More or less, all these factors are manageable and eventually suggest the right methods of overcoming an instability process, even if the disruptive social shifts should not be overlooked<sup>7</sup>. But it is the possibility of

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<sup>7</sup> Salehizadeh (1998) referred in his study to more than one million jobs vanished in the aftermath of the 1994-1995 Mexican peso crisis. Likewise, Business Week in his coverage "Global crisis. Time to act" of September 14, 1998, points out to the prevalent uncertainty and dissuaded belief in free market

*arbitrary* occurrence of financial crisis which seems to concern mostly the economists. Is the stability of the world economy really doomed to the whims of the individuals and is it bound to happen frequently and erratically?

Krugman (1997) embarked on this kind of argumentation and made clear his support to the uncomfortable conclusion that "the complaints of countries that they are being unfairly or arbitrarily attacked [by market manipulation] have at least some potential merit." One reason stems from the herding behavior of most of the financial players, led by incomplete or distorted information. The evidence is that sheer imitation is strongly embedded in the market functioning, what may finally transform a possible rational move into an apparently inexplicable pressure on a country's currency.

Another important explaining factor results from the speculative operations of important financiers, as the George Soros' attack on the British pound in 1992 showed once again that it is possible. Similarly, the failed speculation, when carried out on a large scale, as the collapse of Long-Term Capital Management, the US hedge fund notably known for its Nobel Prize winners collaborators, creates panic and questions the validity of current economic orthodoxy.

What makes the financial instability all the more an alarming theme is the economists' incapacity to present a common, or at least a similar opinion. Contrasting explanations offered by respectable theorists actually make more visible the vulnerable part of the international finances.

For instance, an appropriate management of currency reserves, and a better devised financial infrastructure could play decisively in reducing the likelihood of speculative attacks, advocate Feldstein (1999) and Stiglitz (1998), both leaving enough room for

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economy after some 100 million middle-class people had been pushed into poverty as a result of the 1997-1998 Asian market collapse.

private initiative and free market operations. On the other hand, Krugman (1997) infers from his analysis on the ERM crises that one can only speak of "the near-irrelevance of foreign exchange reserves in a world of high capital mobility".

Irrespective of any conjecture one can make on the causes and consequences of the present highly liquid financial markets, the ongoing changes signal a different economic environment than we were used to even ten years ago. The next task is to identify the feasible trade policy responses to them.

#### **4. Trade policy response to the capital flows' instability.**

Next to the advances in technology, the liberalization of the capital flows after the 1970s have probably contributed mostly to the transformation of the commercial exchanges in the sense that the individual actor, increasingly uncoupled from its country of origin, has become the most important player in the world trade arena. The more mobile capital becomes internationally, the easier a company can locate its production and deliver its products from every part of the world. The famous Ricardian argument of free trade seemingly losses ground day after day.

The argument holds true for the most part of the international trade. Simple arithmetic emphasizes the dominance of the large and influential firm. Korten (1995), quoting *The Economist*, signals that only five companies control 70% of the consumer durables market, 50% of the automotive, airline, aerospace, electronic components, electrical and electronics, steel markets, respectively, and 40% of the oil, personal computer, and media industries markets, respectively. Other meaningful data show that 70% of world trade is controlled by 500 corporations, whereas only 1% of all multinationals own half the total stock of FDI.

However, this is not the whole picture. General prosperity is too much infused with

regional disturbances, which usually encompass firms or countries too feeble to defend themselves. In this respect, hearing from an authoritative source, as the IMF, that “sound management of fiscal and monetary policies provides no guarantee against major economic crises” is profoundly disconcerting<sup>8</sup>.

Against this background, trade policy is accordingly conducted more than ever depending on the sphere of transnational interests a country is willing and able to embrace. Foreign direct investments and M&A operations clearly set up anew the dominance of the large firms, capable of moving freely in the international context and inducing their own favorable rules of the game.

It was documented (World Trade Organization, 1998 and UNCTAD, 1998) that FDI dynamics underpin substantially world trade, by means of superior sales growth of the multinationals. At present, foreign affiliate exports account for one-third of world exports, and, more impressively, seem unaffected by the recent turmoil in the financial markets. At the same time, most developing countries have benefited from their presence by building and promoting competitive export industries.

At the same time, the possibility to undertake M&A transactions on a larger scale changes considerably the power balance within different industries and creates new opportunities for trade. Thus, it is obvious that the circular interdependence between investments and trade broke down and made room to a new causation implying a more active role for firms in determining the location of their production facilities and the origin of their exports and imports.

Consequently, the governments become more involved in influencing the “external appeal” of their economy and the new pattern of trade, rather than designing new instruments

of industrial policy. While the classical, neutral determinants of investments and trade, such as geographic location, low costs and home market size are becoming less important (UNCTAD, 1998), it may be remarked that the present demands of multinationals, as access to technology, innovative environment, information-facilitating infrastructure, to name just the most important of them, require a more active government in order to attract the bulk of the outflows.

On the other hand, the recent megamergers remind some economists<sup>9</sup> of the old times when just one company could exert considerable pressure in its relationship with some political entities, as discussed in part 2. While the official financial assistance gradually diminishes its importance, private lenders supplanted it on the grounds of more available financial potential. This trend considerably changes the balance of power in favor of the big, powerful company, leaving the governments the only alternative to accommodate accordingly their policies or to play passively a peripheral role.

World Trade Organization has taken on the meritorious role of coordinating the efforts in the field of commercial policy in order to have an appropriate answer to these challenges. Some of its mechanisms, for example dispute settlement, trade policy review, have been successful in bringing in under the same umbrella the countries’ interests, irrespective of their size.

Moreover, important steps have been taken toward addressing the financial aspects of trade through the conclusion of the General Agreement on Trade in Services (GATS). The agreement, which was warmly received by a trading community representing 95 per cent of the global financial service market, deals with liberalization of trade in banking, insurance and other financial services.

<sup>8</sup> Quotation in *Business Week*, Special report, October 12, 1998.

<sup>9</sup> Jeffrey Garten, *Megamergers are a clear and present danger*, in *Business Week*, January 25, 1999.

On the contrary, in the field of international finance, it is still hard to reach the same denominator as to the approach to be pursued on behalf of the two great institutions, the International Monetary Fund and the World Bank Group. The contrasting views of their representatives have lately become notorious. As a result, some economists have recently taken into consideration a new financial global architecture, which would comprise a World Financial Authority, complementary and more similar in its responsibilities to the WTO (Eatwell and Taylor, 1998).

Somewhat surprisingly, recent overviews of world trade report no fundamental reversals in the direction of trade policy towards protectionism, including in those countries most directly affected by the crises. As Bhagwati (1998) remarked, this seems to be the only rational attitude in order to minimize the effects of financial instability.

Indeed, there is no prerequisite to suppose that a comeback to widespread protectionism could be still possible, and much credit for this comfortable conclusion is to be given to the WTO efforts. Nevertheless, the local disturbances and weakened positions brought about in the aftermath of most of the present financial crises will arrest for the time being the fervor for an unhindered liberalization of the capital flows. The examples of Chile and Malaysia, which successfully imposed capital controls in spite of the orthodoxy advocated by the IMF, stands for a turning point in the practice of international relations.

At the same time, the virulence of the financial crises, amplified by the impressive amount of circulating capital, undermine the efforts of less developed countries to fully integrate in the world trade system. The most considerable influence stems from the exchange rate instability and commodity prices volatility.

The large swings in the exchange rates constitute an issue of great concern, both for the government, and the businesses (Lessard, 1980). A sudden, large drop or increase in a currency's value exerts its direct impact on

competitiveness, by ascribing an unreal value to imports and exports, and hence rendering erroneous signals as to the efficient allocation of resources.

The effect is amplified further by the underdeveloped domestic financial system, unable to undertake free capital mobility without subsequent damaging consequences. Under these circumstances, argues Liang, (1993), the country may cease exporting the good in which it has comparative advantage if the uncertainty associated with its production becomes large enough. Thus, the undesirable effect of "export diversification" will become a distinctive feature of that economy.

Commodity markets' volatility is a point which deserves similar concern as well, primarily because it constitutes a major source of instability and uncertainty for commodity-dependent developing countries. The export dependence on several leading commodities is pervasive among developing countries, and in some cases quite vital. The fall of petroleum prices to the level of \$11.88 per barrel from approx. \$20 per barrel in the aftermath of the Gulf War put through an ordeal some 25 countries dependent on this product for 20 % or more of their foreign exchange earnings (UNCTAD, 1999).

Larson et al. (1998) argues that hedging risk by means of derivatives markets is not an easy choice for most of the developing countries for reasons ascribed mainly to the

particularities of commodity markets, and, again, to the insufficient development of a proper financial infrastructure.

### **5. Concluding remarks**

The recent developments in the global economy imply a rapid compliance with the new rules in order for the states to reap fully the benefits of the new economy and to protect themselves as much as possible from its destructive forces.

The key question is how a country could minimize negative effects and maximize positive effects of capital flows through appropriate policies. The concepts of equilibrium and natural movement of assets prices are not supported by the present economic context, characterized by frequent episodes of instability. It is rather a continuous process of responsiveness on behalf of the states. It is the search for a pragmatic approach that should guide the governments' economic policies, rather than a comfortable agreement with the conventional wisdom.

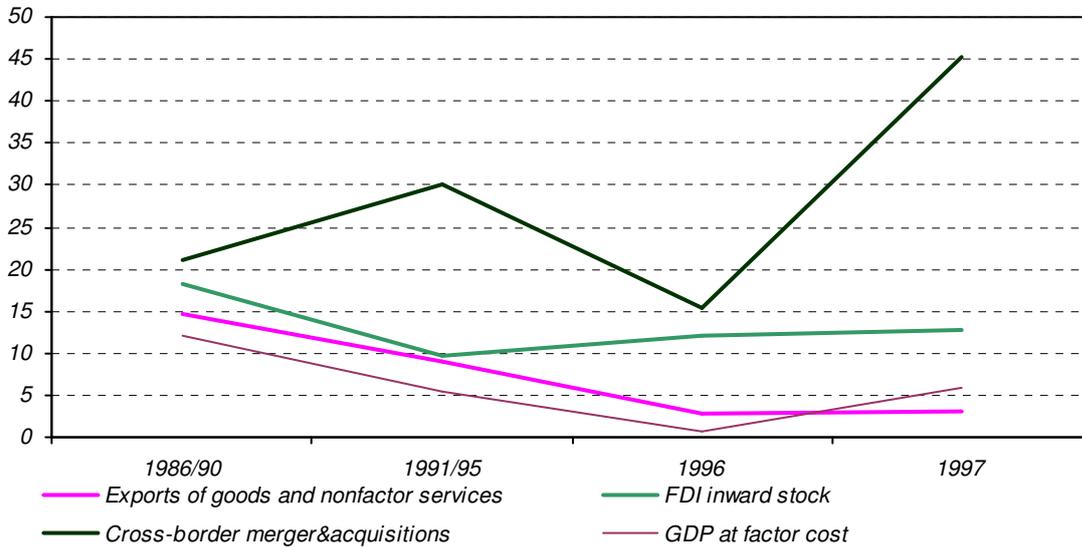
Entering this path of argumentation is often conducive to the plain rejection of the orthodox theories, specifically, the principle of free movement of goods and services in international trade. Careful not to be trapped so easy, this study's argumentation just supplements it with some guiding tenets. The

commercial exchanges will develop in the new context by resorting more often to the market institutions and by exploiting the viable opportunities. It will be a sort of more attentive designed behavior, not in despise of market rules, but intimately embracing them.

The trade patterns of individual countries are now increasingly determined by the strategies of individual companies rather than national policies or comparative advantages. The great financial power they make use of enables them to move freely all around the globe and to pay little attention to some national goals. Co-ordination, as regards the need to mitigate the negative impact of the global capital, and pragmatism, as regards the need to understand the new rules of the game, seem to represent some necessary concepts for competing internationally today.

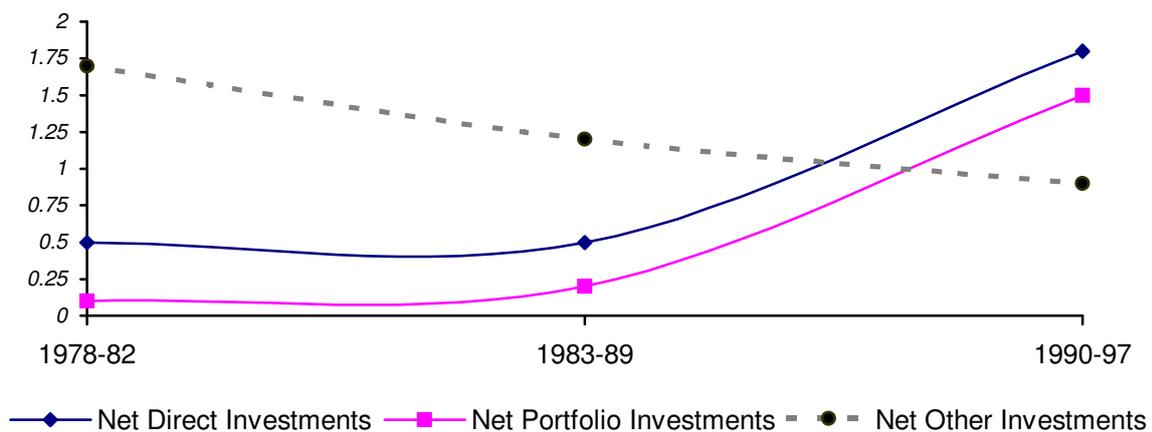
## ANNEX

Graph 1: Trends in the International Economic Flows  
*Annual growth rate*



Source: Mallampally, P., & Sauvant, K., P. (1999). Foreign direct investment in developing countries, *Finance & Development*, 36(1): International Monetary Fund.

Graph 2: The Economic Weight of the Financial Flows for the Developing Countries  
*Annual capital net flows as percentage of GNP*



Source: Lopez-Meja, A. (1999). Large capital flows: a survey of the causes, consequences, and policy responses, Working paper WP/99/17, International Monetary Fund.

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