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Financial Globalization and Its Implications for Development

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1 Introduction

Since the 1970s, a policy approach has become increasingly predominant that placed financial markets at the center of development aims. Together with financial liberalization, this has been a major factor in the fast rise of financial activity, nationally and internationally, with finance taking by far the leading place in economic globalization. Globalization has growingly become a finance-led process, with significant pro-cyclical implications for development.

There is increasing consensus that different aspects of a globalized economy have very different effects on growth, investment and jobs. While there is widespread agreement that trade has net positive effects on growth and jobs (though there are important issues about distribution of gains and losses, how trade liberalization is performed, and degree of contribution to growth), there is increasing evidence that, in contrast, capital account liberalization and unfettered capital flows—especially more short term and reversible

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ones—may have no or negative effect on growth, capital formation, jobs and income distribution.

Furthermore, the view has emerged that excessive liberalization of the capital account, without corresponding regulation of these flows when appropriate, may actually undermine—rather than support—trade growth. This was evidenced, for example, by the negative effects on the evolution of global trade caused by the financial crisis of 2007–2008, with the growth of trade well below its pre-crisis rate of increase still in 2016.

Therefore, those who support free trade may be particularly keen to regulate excessive, and especially short-term, potentially reversible capital flows, as for example one great supporter of free trade, Jagdish Bhagwati (Bhagwati 1998). At a national level, many economists concerned with maximizing growth and employment are fearful of the macroeconomic instability and harm that external capital flows and ensuing currency crises may pose, as well as the distortions, for example via overvalued exchange rates, that may undermine the growth and value-added of their exports (Ffrench-Davis and Griffith-Jones 1995, 2004).

In what follows, in Sect. 2, we look at the historical evolution of these ideas and the underlying empirical evidence. In Sect. 3, we examine recent debates around capital account liberalization and examine the 2012 "institutional view" of the International Monetary Fund (IMF), which under certain conditions favor capital account regulations, and their contradiction with World Trade Organization (WTO) and, especially bilateral trade deals. We therefore call for an aggiornamento of WTO and bilateral trade provisions. Then, focusing the analysis in emerging economies, Sect. 4 examines why financial capital flows tend to be naturally pro-cyclical, overshooting both in the boom and in the bust. Section 5 discusses the implications of structural heterogeneity (SH) and some of the asymmetries which result from this feature in combination with real macroeconomic instability; the implications are regressive and depress development, owing to their effects on capital formation, the quality of exports, employment rates and jobs. Section 6 presents the concluding remarks.

2 Historical Context

The view that capital flows had destabilizing effects in the 1920s and the 1930s shifted policy opinion in favor of managing the capital account in the 1940s. Capital account regulations (CARs) became widespread features of economic policy management, even in developed countries. The 1944 Bretton

Woods Agreement, that established the IMF and the World Bank, followed this view which then was the mainstream one. Countries were allowed to regulate capital flows according to their domestic policy priorities. Keynes and White, the creators of the Bretton Woods system, saw free capital flows as a large source of financial instability and of the collapse of the world economy in the 1930s; in the discussions that preceded the 1944 Bretton Woods Agreement, they strongly defended countries' rights to the full freedom to manage their capital accounts (Keynes 1942–1943). They thought that international capital movements should not be allowed to disrupt the policy autonomy of states to adopt the monetary policy stance consistent with their domestic priorities, in order to achieve, in particular, the key objective of full employment, so dear to Keynes (for an excellent analysis, see Ocampo 2017).

The change toward capital account liberalization since the mid-1970s, which started with the US was soon followed by other developed countries, which together with booming capital flows reversed the previous mainstream viewpoint, with capital account openness becoming the new orthodoxy. After developed countries liberalized capital accounts, the pressure on emerging and developing countries to liberalize their capital accounts became a central issue. International institutions, like the IMF, the World Bank and the Organisation for Economic Co-operation and Development (OECD) encouraged or pressured these countries to liberalize.

A number of currency and financial crises followed in the emerging economies. Indeed, those countries that liberalized their capital accounts soon became more prone to currency and financial crises. Thus, a large number of middle-income countries, especially in Latin America, opened their capital accounts in the late 1970s; this was followed by the major debt crisis they experienced in the 1980s, which led to their "lost decade to development" (see, e.g., Griffith-Jones and Sunkel 1989). Similar crises followed in other emerging economies, particularly after they liberalized capital accounts and their domestic financial markets; this happened most notably in the highly successful East Asian "tigers", which suffered a major financial crisis in the late 1990s, subsequently transmitted to the rest of the developing world, particularly seriously when it spread to Russia, and briefly threatened to affect the US markets.

A major problem for developing countries was the particularly strong procyclical swings in external financing and the associated macroeconomic risks they generated (Prasad et al. 2003; Ocampo et al. 2007).

A rather more unexpected situation for *mainstream thinking* was when financial crises also occurred in the deepest financial markets in the world, the US and Europe (Krugman 2011, Rajan 2011). The 2007–2008 crisis was the worst

collapse of major global financial centers since the Great Depression, leading to a sharp fall in output, investment and employment in developed economies, particularly severe for peripheral European countries, especially Greece (Borio 2016). Outside the US and Europe, there was no global financial crisis as such, but a significant contagion of the recessive effects of the crisis in the US and Europe on emerging economies. The drop in economic activity brought a remarkable slowdown of the growth of world trade that had in previous decades become such an important engine of growth. Thus it was shown that unregulated liberalization of finance tended to undermine the expansion of trade.

These events showed that the problems were not restricted to emerging economies, but reflected deeper patterns of behavior of international capital markets.

The 2007–2008 financial crisis led to a significant review in thinking on effects of financial and capital account liberalization. As part of the recognition that financial stability requires strong prudential regulations, including regulations that focus on the macroeconomic dimensions of financial stability, managing capital flows has been accepted by some key relevant institutions (like the IMF) and leading economists (see e.g., Ocampo and Stiglitz 2008) as part of the family of 'macro-prudential' regulations: in particular, with respect to the case of emerging countries subject to strong boom–bust cycles in external financing, with sharply negative effects on growth, investment and employment. This has been reflected in a moderate reversal of the capital account liberalization trends that had spread since the mid-1970s, as well as in the IMF's adoption of an 'institutional view' on capital account liberalization and management in 2012, which recognizes costs of capital account liberalization and benefits of capital account management or regulation (Ocampo 2017).

Financial cycles are a feature of financial markets, as underscored by Kindleberger (Kindleberger and Aliber 2011) and in Sect. 5 later. According to the IMF, financial market volatility has increased over time and has spread to transactions that were considered to be less volatile—particularly foreign direct investment (IMF 2012).

One important characteristic of global finance has been the very strong boom–bust cycle of cross-border finance among *developed* countries (Borio 2016). After 2007–2008, there was a collapse of cross-border finance, particularly sharp for peripheral European countries, with behavior patterns even more marked than those of emerging economies in previous decades. This showed that the problems were not restricted to these economies, but reflected deeper patterns of behavior of international capital markets. This begs the question whether capital account management should also be an option for

developed economies, which have in recent decades fully liberalized their capital accounts.

3 Debates Around Capital Account Liberalization

Advocates of capital market liberalization believed that, by overcoming the negative effects of "financial repression", this would increase economic efficiency, reduce risk and strengthen macroeconomic discipline. Additionally, opening up the capital account would, according to this view, improve the allocation of savings, strengthen capital formation and, therefore, growth.

3.1 Critique of Capital Account Liberalization

The crucial assumptions of this view are that it assumes well-functioning and *complete* capital markets (e.g., limited information imperfections, short-term as well as long-term segments and perfect forecasting of future events), and inter-temporal smoothing. However, these characteristics are generally absent in financial markets (Stiglitz 2008). Critics of capital account liberalization—and financial liberalization in general—have, therefore, pointed out that it could result in severe financial crises with high development costs. In Sect. 4, we go further, arguing why agents managing unregulated financial flows tend to be intrinsically pro-cyclical, and their actions tend to deter capital formation, the level and quality of exports and employment, and the inclusion of small and medium-sized enterprises (SMEs) and new entrepreneurs.

According to these alternative views—based on the actual behavior of markets—the pro-cyclical nature of capital flows and the volatility associated with open capital accounts may lead to *more* rather than less macroeconomic volatility. The uncertainties associated with volatile financing may reduce investment and its efficiency, thus diminishing economic growth, as well as employment. Similarly, the sort of discipline imposed by open capital accounts on macroeconomic authorities is not necessarily that one positive for long-term sustainable growth, as it may reduce the space for counter-cyclical macroeconomic policies and structural reforms needed for higher growth (Ocampo 2017; Ffrench-Davis 2010b; Ffrench-Davis and Griffith-Jones 2004).

Although the evidence that capital account liberalization was not associated with faster economic growth or higher levels of investment had important precedents (e.g., Rodrik 1998), the position that the effects of capital

account liberalization was problematic, was greatly strengthened by a major IMF study published in 2003 (Prasad et al. 2003). This showed that there is overwhelming empirical evidence that financial liberalization increases real macroeconomic instability in developing and in developed countries. Procyclical capital flows have been at the heart of many of the crises in the emerging and developed world since the 1980s, either as causes or as mechanisms of propagation. Further evidence came from later studies which show that countries that have grown more are those which have relied less, not more, on capital flows for growth and have therefore run stronger current account balances (Jeanne et al. 2012).

The economic effects of capital account liberalization also have negative impacts on income distribution. There is, indeed, an empirical relationship between capital account openness and income inequality, which is associated with the fact that inequality frequently increases after capital account liberalization. Recent evidence in a 2017 IMF study (Furceri et al. 2017), using rigorous econometric analysis, shows that capital account liberalization increases inequality. The effect of external financial liberalization on inequality depends crucially on the mix of capital flows. Short-term debt flows may increase the chances of sudden stops and financial crises, harming growth on average while also raising inequality. Ocampo (2017) gives additional explanations of the link between capital account liberalization and inequality: the increasing mobility of capital weakens the bargaining position of labor, and international financial integration may constrain governments' redistributive policies.

3.2 IMF Returns to Its Roots, But WTO and Bilateral Trade Deals Lag Behind

There has thus been a revival of views on the positive role that capital account management or regulations can have in the international system. This represents a partial return to the original Bretton Woods Agreements, abandoned in the era of capital account liberalization.

The G-20 adopted, during its 2011 Summit, a set of "coherent conclusions for the management of capital flows" (G-20 2011), but the most important multilateral effort to rethink the role of these regulations was by the IMF in 2011 and 2012, which was approved by the IMF Executive Board (IMF 2012). This was backed by significant research by IMF staff (see, in particular, Ostry et al. 2011, 2012). As a result, the IMF has recognized that capital flows

carry risks and that, under certain circumstances, capital flows should be regulated to moderate both surges and sudden stops in external financing.

The IMF thus recommends countries could use capital flow management measures alongside other macroeconomic policies: counter-cyclical monetary and fiscal policies, active foreign exchange management and macro-prudential domestic financial regulations. However, IMF emphasized that capital flows management should be used only after other instruments of macroeconomic policy management have been adopted and thus as a sort of "interventions of last resort" (Gallagher and Ocampo 2013).

The IMF continues to advocate for the liberalization of the capital account as a long-term objective, which is problematic, as said, since the existing literature overwhelmingly finds severe risks associated to full liberalization of the capital accounts, especially—but not only—in emerging and developing countries.

A more ambitious pro-development policy framework would recognize that capital account regulations (CARs) should be used by countries receiving such flows, on a permanent basis, as an integral component of a counter-cyclical macroeconomic policy package, preferably based on permanent regulations that are strengthened or weakened in a counter-cyclical way, and modified according to developments in global and local capital markets (Ocampo 2017).[1]

In the meetings leading up to the establishment of the IMF, both White and Keynes agreed that capital controls be targeted at "both ends" of a capital flow (Helleiner 1994). Furthermore, the industrialized nations are more often the source of such flows but generally ignore the negative spillover effects of their actions on other economies. In particular, the expansionary monetary policy by the US, for example after the 2007–2008 crisis, instead of channeling resources to the US economy flowed to emerging economies, creating problems there such as overvalued exchange rates.

Capital account liberalization was also harming developed countries during their efforts to recover their economies, as well as emerging ones. There is therefore a strong case for also regulating outflows from source countries to other economies, when these become *excessive*. This would be a complement to measures regulating capital flows in recipient countries, which are essential. Indeed, one important aim of regulating cross-border capital flows, in both recipient and source countries, is the reduction of systemic risk buildup in

[1] This alternative framework, beyond the IMF position, is the result of an academic debate that took place while IMF Board discussions were going on. See a full collection of contributions to this debate in Gallagher et al. (2012), particularly on guidelines for the design of capital account regulations (CARs) as an essential part of the macroeconomic policy tool kit and not seen as measures of last resort.

both of them, thus reducing risk of future crises. Such measures of managing excessive capital outflows from developed countries, and especially from the US in times when these were excessive, could be a rare "win-win" opportunity, as they would benefit both the US and the emerging economies (Griffith-Jones and Gallagher 2012). It is encouraging that IMF authors (Ghosh et al. 2014) have shown the benefits of regulation of capital flows in both source and recipient countries, and argued for the value of coordination of both, to make them more cost effective.

All recipient countries should have the freedom to manage their capital account according to national priorities. The latter would require modifications of OECD recommendations and requirements, but more importantly of EU rules.

In any case, a major advance of the IMF institutional view was the recognition that there is no obligation to adopt capital account convertibility under the IMF Articles of Agreement. Countries have therefore full freedom to manage their capital account (Ocampo 2017).

A serious problem is that the policy space provided under the IMF Articles of Agreement, and its new decision is being eroded by trade and investment agreements. Increasingly, these agreements prohibit the use of capital account regulations, and those treaties that have exceptions for measures to manage balance-of-payments crises only allow these regulations to be temporary. The IMF has itself noted that its own recommendations and the freedom that countries have to adopt capital account regulations under its Articles of Agreement are often at odds with other international commitments, in particular trade and investment treaties that restrict the ability to regulate cross-border finance.

Indeed, many trade and investment treaties lack the appropriate safeguards (Gallagher and Stanley 2012). This is true if countries have made commitments on financial service liberalization within the WTO and OECD but, more importantly, is true of several regional and bilateral agreements. In particular, in treaties with the US, it is stated that all forms of capital must flow "freely and without delay" among trade and investment partners (Ffrench-Davis et al. 2015).

Such provisions should be revised to make them consistent with the IMF's provisions under its Articles of Agreement. The key point here is that these provisions reflect largely, if not fully, the historical evidence, as well as the most rigorous academic empirical analysis on the costs of capital account liberalization and benefits of capital account management. Furthermore, the IMF is the main international institution dealing with issues, such as capital flows. Unfortunately, WTO—and especially bilateral trade and investment

agreements (most often with the US)—does not reflect the new agreed consensus among economists, based on empirical evidence. There is, therefore, an urgent need for an "aggiornamento" of the views reflected in WTO, especially in bilateral trade and investment deals. This will help increase favorable effects of capital flows on growth, investment and employment, as well as encourage trade flows, as discussed in detail earlier and later.

4 Why Financial Capital Flows Are Intrinsically Pro-cyclical

Financial flows have been, by far, the ones that have led economic globalization in the three recent decades, with a strong pro-cyclical performance (Korinek 2011; Ostry et al. 2016). While international trade of goods and services increased its volume at 6% per year (doubling the gross domestic product [GDP] rate) and foreign direct investment (FDI) at around 10%, financial flows were expanding those rates several times. In fact, it is estimated that international financial flows account for 40–70 times the value of world exports plus Greenfield FDI. A large amount of financial flows move several times during the course of a day, while exports take days or even weeks between its departure and arrival to their final destination.

It is often stated that diversification reduces risks and instability, which is in general true. However, the considerable diversification experienced by capital flows had been registered with an intense pro-cyclical volatility. For close to the four decades that followed the depression of the 1930s, financial flows were notably limited. Later, gradually, international bank lending as well as international bond markets re-emerged, while flows to stock markets, American Depository Receipts (ADRs), mutual and investment funds, derivative instruments proliferated, including toward emerging markets. To the growing foreign flows, there would be added flows from domestic institutional investors and other residents in these economies, which also became increasingly globalized. As a matter of fact, a great diversification of international financial flows took place, but one that has involved strong and recurrent volatility. Most of these flows tend to share concomitant contagion of boom-and-bust cyclical processes.

An outstanding feature of recent macroeconomic crises in East Asia and Latin America is that they have affected economies classified as "successful" by international financial institutions, financial agents and risk rating agencies. As a consequence, emerging economies have been "rewarded" with large flows

of private capital and diminishing spreads, in parallel with a buildup of increasing volumes of external liabilities during the boom periods.

The recipient countries have thus moved into areas of vulnerability: varying combinations of growing and liquid external liabilities; domestic credit booms; currency and maturity mismatches; substantial external deficits; appreciated exchange rates; high stock market price/earnings ratios; high prices for luxury real estate; and low rates of productive investment. At the same time, macroeconomic expectations have largely come to be dictated by the opinions of agents specializing in short-term segments of the financial market.

As said earlier, there is a substantive literature on sources of financial instability: information asymmetries between lenders and borrowers and a failure to properly assimilate the negative externalities generated by each agent (in the form of growing vulnerability) have created the basis for cycles of abundance and scarcity of external financing (Krugman 2000; Rodrik 1998). The tendency to equate opinions and expectations with "information" contributes to a herd mentality and to multiple equilibriums. And there have in fact been episodes of runaway contagion, first of excessive optimism and then of excessive pessimism, in the financial crises experienced over the last three decades, these imbalances often being encouraged by the risk rating agencies.

An obvious contagion of overoptimism among lenders tends to be characterized as risk "appetite" among the agents following the "leaders", but what prevails is ignorance or underestimation of the underlying risks.[2] Meanwhile, as discussed later, the "leaders" tend not so much to have a particular appetite for risk as to believe on one-side bets assuming capital gains are assured. As regards borrowers, at times of overoptimism, the evidence is that most of them do not borrow with the intention of not repaying or in the hope of being bailed out or benefiting from a moratorium. What usually prevail are rather expectations of large benefits—from continued currency appreciation, for example. Borrowers also fall victim to financial euphoria during booms.

Beyond these factors, two further characteristics of financial creditors are of vital relevance for explaining why they tend to exhibit an intrinsically procyclical behavior. One is the particular nature of the leaders acting on the supply side. There are natural asymmetries in the behavior and goals of different economic agents. Agents oriented toward the financial markets are specialists in liquid investment, tend to operate within short time horizons, as are

[2] Calvo and Mendoza (2000) examine how globalization can spur contagion by discouraging the collection of information, as it creates stronger incentives to imitate the portfolio of the market. This introduces an information asymmetry, now between market "leaders" and "followers".

remunerated for short-term profits, and thus are extremely sensitive to changes in the variables affecting short-term returns.

The second characteristic is the gradual spread of information about investment opportunities in emerging economies among agents who are in a position to expand supply. Agents in the different financial market segments are gradually attracted to new international markets as they learn of profitable opportunities in emerging economies that they had hitherto overlooked or been unaware of. This explains, on the supply side, why capital flows have followed a rising path, in many of these countries, over periods of several years rather than there being sudden one-shot upward shifts in the supply of capital.

Feedback effects have been generated by the existence of installed capacity (potential GDP) that has been underused at the start of each of these processes and gradually brought back into operation during the upturn; this is something the authorities, markets and certain econometricians have often wrongly interpreted as a persistent structural increase in total factor productivity (TFP).[3] All this is self-reinforcing so that some variables—stock markets, exchange rates, risk ratings and real estate prices—can move in a particular direction, first recovering and then overshooting, so that they move away from sustainable equilibrium for prolonged periods, offering economic agents the "assurance" that financial markets will move in only one direction and stimulating capital flows that pursue capital gains (rent-seeking flows).

This being so, it is important to highlight the significance for public policy design of the distinction between two different types of volatility in financial capital flows: short-term or random-walk fluctuations and medium-term instability. The latter means that variables such as the exchange rate, stocks and shares as well as real estate prices can move persistently in a particular direction, giving the market the false assurance already mentioned of asset prices and returns moving in a single direction. This stimulates further continuing flows that at some point become increasingly detrimental to macroeconomic fundamentals, but that still offer successive short-term windfall gains. These agents naturally specialize in the search for capital gains rather than productivity gains, until asset prices and the real exchange rate reach what are clearly outlying levels. Then someone sounds the alarm and there is a rush to reverse flows, with a strong and costly pro-cyclical bias. Unlike fixed capital investment, which is to a large degree irreversible, this financial capital is wholly reversible.

[3] A systematic distinction between potential GDP and actual GDP would allow this faulty interpretation to be avoided, being an essential component of a development-oriented macroeconomic policy.

Financial creditors' sensitivity to bad news will increase greatly at some point (and probably quite abruptly) once the country has entered "areas of vulnerability". Then lenders will take note of: (1) the volume of assets they hold in that market, (2) the degree to which that market depends on additional net flows that is linked to the current account deficit, (3) the level of exchange-rate appreciation, (4) share price/earnings ratios and (5) the stock of short-term and liquid foreign exchange liabilities of the country. It is therefore unsurprising that expectations become more and more likely to reverse, as valuations move further into these areas of vulnerability.

The deeper and longer-lasting an economy's incursion into areas of vulnerability, the greater the likelihood of crises and more severe are their effects. This highlights the crucial need to implement effective regulations to ensure that capital flows are not excessive, that they strengthen productive investment and are consistent with a sustainable macroeconomic environment.

Consequently, both the accumulation of external assets by suppliers of financial inflows, until this expansionary stage of the cycle is far advanced, and the sudden subsequent reversal of flows can be considered "rational" responses by individual agents, given their short-term horizons. This is because the question of whether the macroeconomic fundamentals are improving or worsening is not relevant to these investors as long as they continue to make financial investments motivated by expectations of short-term returns, and they believe they can pull out quickly before the situation deteriorates. What does matter to them is whether the indicators which are critical from their standpoint—real estate, bond and share prices and the exchange rate—can continue to yield short-term gains and, of course, whether markets are liquid enough for them to reverse their decisions timely if necessary. They will thus continue to originate net inflows until rising expectations of an imminent reversal emerge.

It needs to be stressed again that, for financial operators, the most relevant variables are not the long-term fundamentals of the country's economy but the short-term returns their loans or investment yields. This explains why their view of a particular country can change radically even though the domestic economic fundamentals, other than foreign currency liquidity and prices of financial assets, may remain unaltered.[4]

After the bust, once debtor markets have made a "sufficient" downward adjustment, the opposite process tends to arise and to be sustained for some years. In conclusion, economic agents specializing in financial investments, who might be notably efficient in their field, operate with short-term plan-

[4] Since economic authorities must take care of the sustainability of macroeconomic balances, it appears "irrational" and perverse that these authorities might follow the advice of "rational" financial investors. Naturally, these pursue their own short-term aims, which often are inconsistent with the long-term aims of financial and macroeconomic stability that should be pursued by government economic authorities.

ning horizons because of their training and the rewards they can thereby obtain, and they have largely dictated macroeconomic developments, owing to the decisive influence they have had on policy design. This means that a "financieristic" attitude prevails over the "productivistic" one (Ffrench-Davis 2010b). This generates a conflict with the twofold objective of growth with equity, which requires better incentives to increase productivity rather than giving priority to financial rent-seeking or capital gains.

The heterogeneity characterizing the capital account in the recent era of financial globalization makes it essential to distinguish between the behavior and effects of its different components. Greenfield direct foreign investment and long-term loans associated with imports of capital goods are relatively stable over the cycle and are indissolubly linked to productive investment. By contrast, since financial flows have shown great pro-cyclical volatility, this very feature means that only a minor share of them have gone into the financing of productive investment; these flows usually end up financing purchases of existing assets and consumption, creating bubbles and crowding out national savings. Often, indeed, they have destabilized the macroeconomy instead of stabilizing it and have not contributed to productive capital formation. However, as pointed out earlier, this distinction between short-term and long-term investors has been somewhat eroded, as even foreign direct investment is associated with pro-cyclical behavior in some aspects.

To sum up, the interaction between two factors—the short-termist nature of leading financial agents and the fact that the recovery adjustment tends to be a process—explains why suppliers continue providing funds even when the real macroeconomic fundamentals are worsening. This implies that countercyclical regulation of inflows, rather than a last resource tool, should be in place before inflows are starting to generate some significant real macroeconomic disequilibria.

5 Recessive and Regressive Asymmetries Under Structural Heterogeneity and Financial Pro-cyclicality

Financial instability tends to be more severely costly, in terms of growth and for inclusion, in economies that exhibit *structural heterogeneity* (SH) and passive or pro-cyclical macroeconomic policies.[5] Here we consider three categories

[5] The concept of *structural heterogeneity* has been developed by the Economic Commission for Latin America and the Caribbean (ECLAC), departing from the more standard concept of *dualism*. For instance, see Rodríguez (2007).

of SH. First, among firms, including the diversity of productivity, access to financing, markets and technology between different sizes of companies. Second, by SH in labor markets, we understand the diversity of the recessive effects on workers of different social status, skills and training. Third, by the diverse capacity for and speed for action or reaction or *asymmetric* response to the economic cycle by the agents typically operating in different domestic markets: consumers versus productive investors, productive investors that generate GDP versus rent-seeking financial investors.

The greater the macroeconomic instability, the greater the asymmetries of reactions and socioeconomic effects will be. This is highly significant in economies experiencing repeated boom-and-bust cycles, which traps average actual output below the productive capacity of labor and capital; this gap results from the extreme fluctuations in macroeconomic prices, such as the exchange rate, as well as liquidity squeezes in aggregate demand, the credit market and sharp swings in the external balance.

The combination of structural heterogeneity and instability leads to considerable public policy challenges; if they are not taken into consideration, both equality and growth usually remain elusive. The supposedly "neutral" policies of neoliberalism often have significant negative effects on both heterogeneity and instability: (1) regressive effects that harm small and medium-sized enterprises (SMEs), start-ups and less-skilled workers, and a drop (2) in the utilization rate of available potential GDP (GDP*), the quality of exports and jobs and innovation, and (3) in the investment ratio that usually is closely linked to output gaps.

Consequently, when designing the domestic macroeconomic environment, two basic features should be borne in mind: that it should enable a closeness of economic activity to the full use of productive resources, with sustainable domestic and external balances, and that it should encourage the building of new productive capacities. Among other conditions, domestic demand needs to evolve in step with productive capacity, or potential GDP, and macroeconomic prices (particularly, the exchange-rate path) should be consistent with a sustainable external balance. This sounds quite obvious; however, it has not been the usual situation in emerging economies in times of open capital accounts and financial globalization.

This section stresses the implications, for capital formation and employment, of the presence of deep structural heterogeneity among diverse types of economic agents under real macroeconomic instability. In emerging economies, macroeconomic instability is closely linked with fluctuations in financial capital flows and commodity export prices.

Real macroeconomic instability implies that, during recessions, actual GDP may be well below potential GDP for long periods of time. However, actual GDP, at most, can exceed potential GDP for only short periods. Of course, during recovery, actual GDP tends to grow faster than potential GDP, until *full* employment is reached. The fact that, in conditions of instability, the economy does not fluctuate around potential GDP, but mostly below it, points to an *asymmetry* that has a significant effect on economic growth and its distribution. The gap between the two is a "recessive gap", indicating underutilization of capital and labor.

A discussed in the following, as long as there is a recessive gap, downward pressure will prevail on capital formation and the quality of employment. Consequently, in order to promote growth and equity, economic output must remain close to the production frontier.[6] Three types of asymmetric responses and effects are examined, which are regressive and depress development under conditions of instability in the real economy and of structural heterogeneity, owing to their effects on capital formation, the quality of trade and its contribution to inclusive growth, and employment as well as job quality. The section concludes with a brief overview of counter-cyclical policy tools regulating capital flows, aggregate demand and the exchange rate.

5.1 Recessionary Gap and Capital Formation

As numerous empirical studies have shown, the recessionary gap between actual and potential GDP (a crucial macroeconomic imbalance) significantly reduces the investment ratio, a key variable for economic growth. The experience of Latin America reveals a strong negative correlation between the size of the recessive gap and the capital formation ratio (ECLAC 2010, chap. II).

Several factors are responsible for this negative link: (1) a recessionary gap implies that available capacity is being underused, which lowers actual productivity (the standard measure of residual or *total factor productivity*); (2) if sales decline, it is not justified for entrepreneurs to expand capacity until their businesses are becoming closer to their existing capacity; (3) lower profits mean that businesses have less internally generated resources to finance new investments, while at the same time deterring investors from risking borrowed funds in irreversible investment; (4) the resulting deterioration in firms' balance sheets usually coincide with a pro-cyclical reluctance by capital markets

[6] For instance, for average Latin America, during most years since the early 1980s, there is evidence of significant recessive gaps during most time of over one-third of a century. See an estimate of the output gap (recessive gap) in ECLAC (2010, figure II.9).

to finance firms facing recession-induced liquidity squeezes; (5) the recessionary gap and its fluctuations tend to affect the quality of project evaluation and tends to discourage productive innovation partly associated to the acquisition of new machinery and equipment (Aizenman and Marion 1999); and (6) large recessionary fluctuations tend to depress public revenue, leading to cuts in public investment needed to complement private investment (Easterly and Servén 2003).

Thus, an array of compelling reasons, related to real macroeconomic imbalances, explain why a poor capital formation rate is closely linked to economic cycles. The negative pro-cyclical macroeconomic impact on capital formation tends to deter or defeat the efforts of a more structural nature to raise productivity and reduce structural heterogeneity through microeconomic and mesoeconomic reforms.

If recurrent recessionary gaps can be avoided, with a counter-cyclical policy that brings aggregate demand close to potential GDP and leads to a sustainable real exchange rate, potential investors could be encouraged to engage more fully. The dynamic effect will be much greater if economic actors have solid expectations about the ability of public policies to maintain the balance of the real economy, and if the authorities also undertake reforms to complement long-term capital markets, stimulate industrial innovation and improve labor force training.

As the recessionary gap gradually disappears, entrepreneurs who had mothballed potential projects will try to revive them. This requires time, given the array of factors needed to get an investment project off the ground. If the gap is closed for only a short time, however, as a result of imbalances that had been building up during economic recovery, many potential investors will not have time enough to develop their project before the next recession begins.

In this regard, the sustainability of the expansionary part of the cycle is crucial to promoting investment (Titelman and Perez Caldentey 2016). During economic recoveries, after a certain lag, gross capital formation gains momentum, but slows down again when the next recession occurs. Therefore, the longer the capacity of capital and labor is close to being fully utilized, the larger the increase in the investment ratio will tend to be. Consequently, real macroeconomic imbalances, such as increasing currency appreciation, with imports rising consistently faster than exports, high consumer debt or aggregate demand systematically outpacing production capacity, must not be allowed to develop during economic booms.

For instance, since the 1980s, it has become customary for the Latin American economies to begin to recover, peak at close to full capacity after some years and to slip into a new recession (Ocampo and Ros 2011). In the

last three and a half decades, the Latin American economies have spent brief time near full use of productive capacity. The 1980s were marked by a major recessionary gap; in 1994 the economy peaked, then falling in 1995; over the course of 1997–1998, it peaked again, followed by another contraction in late 1998; in 2003–2004 another boom began, which was stopped by the brief contagion of 2008–2009, with a return to growth in 2010–2012, and returning to a recessive gap in 2013–2017. A similar boom–bust kind of cycle, of economic activity linked to capital flows, took place in the periphery of the Eurozone (especially in Greece but also in Spain, Portugal, Ireland and Cyprus), before and after the Eurozone sovereign debt crisis, with equally or bigger problematic effects, as well as in other regions previously.

In summary, capital formation declines heavily in each recession and its recovery in boom periods tends to be gradual and lagged, depicting another deep asymmetry. The gap thus remains and depresses the sum of investment flows during the entire adjustment process, even if the marginal flow by the end of the cycle is similar to what it was at the beginning. Unfortunately, high rates of capacity underutilization have been the norm, owing to real macroeconomic instability, generated by volatile capital flows and export prices, as well as pro-cyclical macroeconomic policies, which have prevented strong gross fixed capital formation ratios from becoming the normal pattern.

5.2 Exchange-Rate Instability and Productive Development[7]

The exchange rate as the relative price that links the domestic and international economies plays a crucial role for the sustainability of macroeconomic balances and for resource allocation. It is a key variable in decisions concerning resource allocation and consumption of tradable and non-tradable goods. The real average and the stability of the exchange rate are both crucial; in conditions of structural heterogeneity and asymmetric responses, exchange-rate instability exacerbates heterogeneity and inequality.

Several emerging market economies have adopted a free-floating exchange rate. However, as the Latin American experience indicates, under this regime, the real exchange rate tends to exhibit an extremely pro-cyclical behavior, which reflects changes in the capital rather than the current account. This means that the exchange rate is determined by short-term capital flows either managed by experts in generating capital gains—not productivity gains—or

[7] See, for example, Williamson (2008), Rodrik (2008), Eichengreen (2008), Ffrench-Davis (2010b) and Ocampo (2011).

driven by reversible terms-of-trade changes, a set-up that fails to take into consideration the sustainability of the current account. Only after a significant external imbalance has accumulated during the boom of inflows, comes a sharp correction. During the boom stage, the currency appreciation process tends to generate structural misallocation of resources. For example, it discourages adding value to exports of primary resources, as well as diversifying exports into new sectors and encourages an excessive consumption of imported goods, and a large deficit on current account, then followed by a sharp depreciation and a recessive gap (output gap).

The free-floating exchange-rate regimes may have prevented the sort of crises typical of fixed nominal rates. However, many of the countries' exchange rates become increasingly sensitive to pro-cyclical changes in the external funding supply or terms of trade, which had severe negative impacts on resource allocation and, particularly, on growth-enabling capital accumulation. Usually, during the transition from boom to bust, the current account adjusts and reserves remain, with no "shortage" of foreign currency, but the domestic economy adjusts with a regressive and depressive recession.

It is often argued that agents can ride out sharp exchange-rate fluctuations by means of derivatives markets, buying or selling futures. When these are available to exporters, and are not too expensive or available only for short periods, futures are an effective means of ensuring current production against price and interest rate fluctuations with respect to today's prices. However, futures prices are, in fact, often quite similar to spot prices. They are not effective at preventing the distorting medium-term allocation effects of instability on investment that, it must be stressed, is a fundamental variable in building productive capacity.

Consequently, another asymmetry often emerges. When cyclical booms start and domestic expectations improve, capital markets become more receptive to funding new projects. But, at the same time, the real exchange rate usually starts to strengthen and creates the expectation that appreciation will persist. This of course discourages investment in the production of tradables and in boosting their value-added. This has not stopped governments from welcoming exchange-rate appreciation on occasions, insofar as inflation targeting takes precedence over growth, employment, exports and sustainable external balance.

The large currency devaluations that often occur in the next stage of the economic cycle tend to stimulate investment in tradable goods. However, this occurs in parallel with the downward adjustment of the economy and usually a rising recessive gap, and under considerable uncertainty, such that financial institutions generally restrict financing for new projects. Consequently, the

market misses the opportunity offered by the depreciated exchange rate to boost productive capacity in tradables. The net result, after both stages of the cycle, is to distort the allocative capacity of the exchange rate and decrease both the production of tradables and their value-added.

Exchange-rate instability clearly distorts project evaluation of investment projects, promotes speculative investment rather than capital formation, artificially crowds out domestic production of importables (many produced by SMEs, which overwhelmingly produce for the domestic market), and discourages value-added in exports.

This severe failure of exchange-rate policy constitutes an acute disadvantage for an export-led development strategy focused on non-traditional exports and higher value-added ones. These exports are the most likely to transmit externalities and to interact with SMEs. A managed flexible exchange rate—in any of its several varieties—is an essential ingredient in a successful export-led development strategy.

The evolution of the real exchange rate must be consistent with economic fundamentals: mainly the current account and the Balassa-Samuelson relative productivity theorem.

In a pro-development, counter-cyclical, approach, then, what is needed is to make real market forces—the producers of exportables and the importers and producers of importables, who are the key players in driving development in relation to the link of the domestic economy with international markets—the strongest influence in determining the evolution of the exchange rate; this must be made under the guidance of the authorities, focused on the sustainability of the current account (Williamson 2008). This is "the market" that should gain ground, the market of generators of real-sector investment, innovation and productivity, not the market of short-term operators and rent-seekers.

In this context, the economic authority must implement a coherent and targeted counter-cyclical capital account management policy, in conjunction with an array of other macroeconomic policies to ensure effectiveness, as summarized later. Otherwise, there is no policy space for an effective macroeconomics for inclusive growth and, thus, development convergence in today's international financial markets. It is inherently contradictory for a developing economy to aspire to converge toward development if strategic macroeconomic prices such as the real exchange rate are delegated to financial operators.

5.3 Quality Jobs and Real Macroeconomic Instability

The labor market structure is a key variable in income distribution in economies with fairly low tax burdens and modest levels of social expenditure (such as the African and Latin American economies).

Creating more and better jobs is crucial to gradually reducing severe inequalities in markets. Macroeconomic policy should consider how its various policies affect large and small businesses, investment and consumption and skilled and unskilled workers in different ways. Gradualism and sound coordination among monetary, foreign exchange, capital account, financial and fiscal policies have a substantial impact on economic growth and its distributive effects, particularly on the level and quality of employment.

As noted earlier, the sharp structural heterogeneity among companies of different sizes and workers with different skills open ways to inequalities in the functioning of markets. Vigorous growth requires much faster gains in the productivity of lower income sectors and, thus, in the employability of the middle- and low-income workers and entrepreneurs. Contrary to the most commonly held neoliberal belief, there is a high level of complementarity among policies that simultaneously contribute to growth and reducing inequality in the labor market (Bourguignon and Walton 2007).

Instability in domestic demand and in the exchange rate has both static and dynamic effects on employment (Ffrench-Davis 2012). Static effects include fluctuations in the utilization rate of available productive capacity in labor and capital stock. The large gaps that emerge repeatedly between installed capacity and actual GDP in turn cause gaps between full employment and actual employment. These recessive gaps and the volatility of variables, such as the real exchange rate, have had profound dynamic effects on (1) the expansion of the domestic capital stock; (2) weakening labor organizations since, when unemployment rises, unskilled workers and smaller businesses usually suffer the most; (3) the value-added intensity of exports and their linkages with the rest of domestic output; (4) the development of SMEs, which tend to be more labor intensive and to compete with imports; and (5) the degree of formality and precariousness of employment and the rate of labor participation.

The deepening of recessive gaps resulting from macroeconomic instability brings an increase in the number of workers into informality and a decrease in the ratio of labor participation. Both imply that the standard figures on overall unemployment underestimate the worsening of labor markets under recessive gaps. Actually, jobs with contracts and social security loose relative weight

in favor of informality and the upward trend in developing countries in labor participation is weakened, given the fact that part of people in working age stop searching when the probability of getting a job decreases under a recessive gap.

One of the links between real macroeconomic instability and inequality is the widespread structural heterogeneity that characterizes developing economies. Given how dominant still is the neoliberal approach, with its belief of homogeneity and policy "neutrality", it is essential to take account of the diverse capacity for action and reaction of typical agents in different markets. Therefore, as stressed, the heterogeneity between large- and small-scale entrepreneurs, skilled and unskilled workers, productive and financial investors and productive investors and consumers must be taken into account, as well as the high domestic and international mobility of financial capital and skilled labor, in contrast with the limited mobility of physical capital and unskilled workers (Rodrik 2011).

The asymmetries resulting from this heterogeneity are intensified by highly unstable economic activity and macro-prices. A boom period leaves large liabilities without an equivalent countervailing payment capacity. The usual shift in expectations, reversal of financial capital flows and sudden devaluations lead to a recessionary adjustment, with drops in domestic demand. This, in turn, exerts a downward pull on production, employment and its degree of formality, and, therefore, on tax revenue. This is compounded by the limited impact of social protection institutions that have limited counter-cyclical and progressive capacity to transfer income in the event of the following crisis, whether in order to seek reintegration into the labor market, training or compensation for lost earnings during the bust (ILO/ECLAC 2011).

In short, given the structural heterogeneity of the markets, instability in the real macroeconomy associated to volatile capital flows and terms of trade has a distinctly regressive effect on income distribution and job quality (see also discussion of empirical literature on this topic in Sect. 3.1). This is an additional important reason for the need for counter-cyclical management of the capital account.

5.4 Counter-Cyclical Macroeconomic Policy Tools and Financial Capital Flows

There is a rich historical analysis of the diverse policy tools used to affect the size and composition of capital flows since the Great Depression, history which in recent years evolved from the decades of strong capital controls since

the 1930s to trilogy of open capital accounts, free exchange rates and inflation targeting dominance since the 1990s.[8] The great recession, after the 2007–2008 crisis, that severely attacked several developed economies, followed by the contagion to developing countries, brought a number of researchers and institutions to revisit the analysis of the effects of capital flows and capital account management on development. As discussed earlier, the previous trend of views biased toward open capital accounts has evolved quite significantly in the direction of considering counter-cyclical (macro-prudential) regulations of flows, opening space for a growing discussion on alternative capital account regulations.

The analysis focused on financial flows and their effects as opposed to Greenfield FDI, particularly considering the pro-cyclicality exhibited by the former flows in recent decades (see Sect. 4). The focus has been mostly on the macroeconomic effects, and the corresponding need for macro-prudential regulations, of which capital account regulations need to be seen as part, as opposed to the previous (pre-2007–2009 crisis) greater focus of institutions like the IMF, Bank for International Settlements (BIS) and other regulatory bodies like the Basle Committee on Banking regulation, more on the micro and almost exclusively domestic financial regulation. This latter approach was shown to be insufficient, especially in the light of the 2007–2009 crisis, as well-thought and well-implemented micro-prudential and purely domestic regulations may be overridden in situations of great macroeconomic imbalances. And these may be generated by pro-cyclical and reversible capital flows, a significant part of which is naturally temporary.

The tools for capital account management may include market-based or quantitative mechanisms, regulating capital inflows or outflows, with a broad or restricted definition of the flows covered. In Ostry et al. (2011), there is a detailed comprehensive analysis of different sorts of regulations of flows. In the case of *successful* developing economies (the so-called emerging market economies), which under the financial globalization of recent decades tend to attract capital inflows, crises have tended to have been built during booms of financial inflows. Usually, a faster growing part goes to nonbanking users, such as consumer credit, real estate and stock market, which are hardly well covered by prudential micro-bank regulations. This frequent fact makes necessary, in parallel, the *prudential* macro regulations or capital controls on excessive inflows in order to avoid the march toward exchange-rate, domestic credit and external accounts disequilibria.

[8] See the relevant, rather critical, analysis of the standard formal *inflation targeting* approach developed in a staff paper produced in the IMF (Blanchard et al. 2010).

A recent paper by Erten and Ocampo (2017) quantify the effects of capital account regulations (CARs). They use four indices of capital account regulations: (1) capital inflow restrictions, (2) foreign exchange-related regulations, (3) financial sector regulations and (4) capital outflow restrictions. Summarizing their interesting research, covering 51 emerging economies from 1995 to 2011, they find that CARs, with the exception of financial sector-specific restrictions, have tended to have desired effects on macroeconomic stability, reducing current account deficits, exchange-rate appreciation and overheating during booms of inflows and have enhanced resilience during the busts and reduced their size, contributing to greater macroeconomic stability. Their results further indicate that increasing the restrictiveness of CARs in the run-up to the crisis moderates the growth decline that follows after the crisis.

We conclude summarizing a case that took place immediately before the period covered by Erten and Ocampo that appears to support their conclusion considering CARs as an essential part of the macroeconomic policy tool kit to be used in a counter-cyclical way to smooth booms and busts, adjusting its intensity with the evolution of the supply of external financing, and not seen as measures of last resort. Given that CARs can be circumvented increasingly through mis-invoicing trade flows, derivative operations or FDIs that are in fact debt flows, they require a significant degree of market monitoring and "fine-tuning" as investors adapt and circumvent regulations (Gallagher et al. 2012).

The experience recorded by the Chilean economy on capital account regulations in its return to democracy in 1990 fulfills these requirements. Chile then was confronted with a boom of external financing. This supply of funding was perceived by the authorities as a temporary (pro-cyclical) excess that would destabilize the exchange rate, its export strategy and a sustainable external balance.

Accordingly, the authorities regulated the amount and composition of capital inflows with a *market-based* tool by adding a cost, particularly, of inflows of loans, bonds and inflows to the stock market. This was done, in close coordination by the Ministry of Finance and the Central Bank, by establishing an unremunerated reserve requirement (URR or *encaje*), calculated as a proportion of each gross inflow, to be held at the Central Bank for a given period; the rate of the URRs and period were adjusted from time to time with the intensity of the supply of external funding. By regulating the composition and amount of inflows, the reserve requirement provided effective room for simultaneously implementing counter-cyclical monetary and exchange-rate policies; actually, there was also an active intervention in the foreign exchange

market by the Central Bank, in a managed flexibility approach (Williamson 2003; Magud and Reinhart 2007; Edwards and Rigobon 2009). In parallel, there prevailed fiscal responsibility, with a public surplus, to serve the debt inherited from the dictatorship. The comprehensive counter-cyclical approach allowed Chile to maintain a level of aggregate demand consistent with its productive capacity and a sustainable exchange-rate path. These equilibria contributed to a substantial increase in the investment ratio and in the potential and actual GDP growth rate, with average GDP rising over 7% a year. However, since 1996, gradually, Chile went along with the policy approach in fashion then and allowed the regulatory power of the URRs and the intervention in the foreign currency market to weaken, reaching the formal liberalization of the exchange rate in 1999 and of the capital account in 2001 (Ffrench-Davis 2010a, chapter VIII).[9] Furthermore, Chilean ability to manage the capital account was weakened when it signed a Free Trade Agreement, with the US, at the insistence of the US Treasury. This illustrates the above-discussed point that trade agreements curtail the ability of countries to pursue the capital account management policies they wish, even if these are in accordance with more recent views of institutions like the IMF. Notwithstanding its weakening, Chilean authorities kept significant room for doing counter-cyclical management of financial flows (Ffrench-Davis et al. 2015).

6 Concluding Remarks

One of the links between real macroeconomic instability, economic growth and inequality is the widespread structural heterogeneity that characterizes developing economies. In fact, the heterogeneity between large- and small-scale entrepreneurs, highly skilled and unskilled workers, productive and financial investors, and productive investors in contrast with consumers, must be taken into account in the design of policies, as well as the high domestic and international mobility of financial capital and skilled labor, in contrast with the limited mobility of physical capital and unskilled workers.

The asymmetries resulting from this heterogeneity are intensified by highly unstable economic activity and macro-prices under the present globalization of financial volatility. For example, when capital inflows are abundant, a substantial part of them is consumed because consumption responds faster than

[9] The counter-cyclical policy in Chile was comprehensive only until early 1996. Several researchers do not take notice of this gradual policy change. Since 1996, the exchange rate appreciated, with rising stock of external liabilities and deficit on current account. When the Asian crisis exploded in 1998, it caught Chile with those (pro-cyclical) macroeconomic imbalances (Ffrench-Davis 2010a, chapter VIII).

investment to an increased supply of funds, and financial markets have become more adept at financing the consumption or purchase of financial assets. If this is accompanied by currency appreciation, as is often the case, the bias is exacerbated by higher imports of consumer goods, which diverts "foreign savings" into national "dis-savings".

Consequently, macroeconomic policies must take structural heterogeneity into account in order to even out different agents' response capacity. This is essential for development, which, inevitably, requires the constant narrowing of productivity gaps and raising average productivity.

Highly cyclical fluctuations in several emerging economies' real exchange rate have distorted investment decisions. The booms of inflows, with the attendant currency appreciation, tend to generate excesses in luxury construction and in imports, which create temporary jobs not sustainable when the growing external deficit has to be corrected. On the other hand, they artificially crowd-out production of tradables that compete with imports (many produced by SMEs). They also discourage diversification toward non-traditional goods more intensive in value-added and the addition of value to traditional exports; they negatively affect sustainable employment and job quality. So, economic booms imply some creation of temporary employment and destroy some more permanent jobs.

A non-stable real economy has asymmetrical distributive effects and implies underutilization of potential productivity, with lower actual output, fewer jobs and an expanding informal sector, as compared with a more stable real economy. Higher rates of capital utilization indicate a higher rate of average employment. The resulting increase in actual productivity and reduced income gaps means that the well-being of workers and investors (wages and profits) can be improved, by making better use of capacity and promoting a virtuous circle of more investment, innovation and jobs. That is the mission of macroeconomic policies, which is to be complemented with productive development and training policies, including pro-development reforms of capital markets.

Productive investors and employment have been subject to great instability in the real macroeconomy, with large recessionary gaps, in a notably incomplete capital market, particularly in financing for smaller firms. Real economy instability has been closely associated with the cycles of financial flows to and from abroad, which, in addition to their great pro-cyclical volatility, have little connection with real-sector investment. "Financierism" has prevailed over "productivism" (Ffrench-Davis 2010b). The main reason for this is the existence of an international financial market dominated by short-term operators, whose behavior is often inherently pro-cyclical and flows are mostly

disconnected from capital formation. Increasing integration with more volatile international financial markets, which often means indiscriminately opening the capital account, has led to greater instability.

Given that fluctuations do not occur symmetrically around full employment, but asymmetrically with clear depressive and regressive biases, several "successful" emerging economies have often exhibited activity levels well below full employment of labor and capital. This situation strongly discourages investment and introduces a regressive bias because of its negative effect on employment and on output. These effects are not distribution-neutral, given the prevailing structural heterogeneity, since the existence of the gap often has particularly severe negative repercussions for SMEs, less-skilled workers and non-wealthy sectors.

The challenge of macroeconomics for development is to design a set of counter-cyclical policies—fiscal, monetary, exchange-rate, domestic financial market and capital account regulations—that takes into account the relationship between the short and long term, reconciles real economic stability with more dynamic long-term growth and promotes social inclusion. This requires efficiently coordinated policies between economic authorities.

Under the current and foreseeable international situation, for these policies to be viable, counter-cyclical regulation of the capital account is needed. Effective and efficient capital account regulation would allow counter-cyclical monetary and exchange-rate policies to be implemented. In parallel, the local financial system needs to be reorganized, in order to channel resources toward productive investment, with an inclusive bias, helping to reduce structural heterogeneity and productivity gaps between different economic agents (Ocampo 2011; Bourguignon and Walton 2007). To this end, a reformed financial system is crucial to reduce high structural heterogeneity of developing economies and facilitate structural transformation and innovation, to achieve a more dynamic, sustainable and inclusive development model, and to provide counter-cyclical finance. An important element in such a reformed financial system is the existence of well-functioning and large national development banks (see Griffith-jones and Ocampo 2018, forthcoming).

Unregulated capital flows have been producing negative effects on macroeconomic stability, economic growth and employment. Consequently, policies geared to manage the capital account would reap the positive effects of capital flows while mitigating or eliminating the depressive and regressive effects of unmanaged flows.

The IMF made a major advance with the recognition that there is no obligation to adopt capital account liberalization, which is consistent with its Articles of Agreement. Member countries have therefore full freedom to

manage their capital account. IMF went further in recommending desirability of using counter-cyclical regulation of capital flows, for effective management of the capital account, as discussed earlier.

However, the WTO and especially bilateral trade as well as investment deals have been often inconsistent with this new consensus of IMF and many academic economists, by including provisions, which limit the ability of individual countries to freely manage their capital accounts, and thus regulate capital flows. A central policy recommendation therefore is that neither the WTO nor bilateral or investment trade deals should contain provisions which limit the ability of individual countries to freely manage their capital accounts, if they feel that capital flows could undermine their national policy objectives, especially in areas of growth and employment, as well as increasing the risk of financial instability and thus future financial crises.

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