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## Stormy Days on an Open Field

Asymmetries in the Global Economy

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### Abstract

Openness is not necessarily good for the poor. Reducing trade protection has not brought growth to today's poorest countries, and open capital markets have not been good for the poorest households in emerging market economies. In this paper I present evidence on these two points. First, countries highly dependent on primary exports two decades ago, despite their substantial engagement in trade and a marked decline in their tariff rates in the 1990s, have failed to grow. Second, within high-debt emerging market economies the financial crises of the last decade, whether induced by domestic policy problems or global contagion, have been especially costly for the poor (in welfare terms if not in terms of absolute income losses). I discuss the asymmetries in the global economy that help explain why countries and people cannot always compete on equal terms on the 'level playing field' of the global economy.

Keywords: globalization, trade, growth, income distribution, development

JEL classification: F02, F1, F43, O1, O15

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## 1 Introduction

Openness is not necessarily good for the poor. Reducing trade protection has not brought growth to today's poorest countries, including many in Africa, and open capital markets have not been particularly good for the poorest households within many developing countries, including many of the emerging market economies of Asia and Latin America. Too often, the word 'openness' has been used to embrace the entire scope of policies and outcomes that characterize a healthy economy. But this makes 'openness' unachievable from a policy point of view. Here, I use the word to refer narrowly to an open trade policy stance, the opposite of protectionism. Defined this way, 'openness' does not in itself guarantee growth, and in some circumstances it makes poverty reduction more difficult.

Many students of globalization have remarked that certain countries and groups have been 'marginal' to the process.<sup>1</sup> It is less often remarked that many have remained marginal despite being, by some measures, 'open'. That this is so is of course perfectly consistent with the evidence that trade is good for growth and growth is good for the poor, since what is true on average need not be true for every country.<sup>2</sup> But it does put a different spin on that evidence, one that raises concerns about the way the global economy is working that market fundamentalists have tended to overlook. The point I want to illustrate is that globalization, as we know it today, is fundamentally asymmetric. In its benefits and its risks, it works less well for the currently poor countries and for poor households within developing countries. Domestic markets also tend to be asymmetric, but modern capitalist economies have social contracts, progressive tax systems, and laws and regulations to manage asymmetries and market failures. At the global level, there is no real equivalent to national governments to manage global markets, though they are bigger and deeper, and if anything more asymmetric. They work better for the rich; and their risks and failures hurt the poor more.

In fact, we think of globally integrated markets as generally open and competitive, providing the paradigmatic level playing field. In the series of contests on this level playing field, there is plenty of room for disagreement and wrangling among teams (countries) about the rules and their interpretation and implementation. But the team owners constitute themselves members of a league (as in the World Trade Organization, the Bank of International Settlements, and so on) and in the interests of the game they

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<sup>1</sup> A stronger statement is that the poor have been 'marginalized'. That word suggests or at least allows for some effort by some party to push the poor to the margin. My point in this paper is that the poor often end up at the margin for reasons reflecting larger structural forces, not explicit efforts of the non-poor to marginalize them.

<sup>2</sup> On growth is good for the poor, the recent study of Dollar and Kraay (2001) has been widely cited. Ravallion (2001) shows that what is true on average is not true for every country or time period.

get together often to agree on the rules, adjust them to changing times, and manage their application. The problem is that a level playing field and good rules are not sufficient to ensure competitive games. If some teams have better equipment, more training, and a long and successful history with money in the bank to sustain the investments that help them retain their advantages, then they are likely to win the league year after year. In soccer the big, powerful and wealthy teams tend to stay year after year in the premier division, and the teams in the third or lower divisions rarely move up. In US baseball the richer, big city teams, such as the New York Yankees, tend to dominate year after year. In sports leagues, however, a lack of competition cannot persist for long. If the spectators lose interest the team owners lose money, so the team owners collaborate to implement rules that minimize the problem—such as the order of draft picks or caps on teams' spending on salaries. Of course 'competition' between countries is not like soccer; it is not a zero-sum game. But for the global economy as a whole, we might think of the global system (of institutions, rules, customs) as playing a role closer to that of the league owners—to collectively maximize overall gains while agreeing on the long-run sharing of the gains. But here the analogy to the global market system breaks down because national governments face much greater obstacles to the kind of co-ordination and collaboration that team owners can manage.

In addition a level playing field is insufficient to ensure competitive games if the rules of the game have been designed to favour one type of team over the other, or if the referee in implementing sensible rules favours one side over another.<sup>3</sup> The protection of agriculture and textiles by rich countries is a good example of an existing set of rules that favours one type of team over another. Sometimes it is the interpretation or implementation of WTO rules that favours one side. The interpretation of TRIPs (the trade-related intellectual property regime agreed at the Uruguay Round) as limiting the use of compulsory licensing in developing countries, even in public health emergencies, for a while reflected backdoor pressure of the United States on the referees. After a contentious negotiation, the interpretation and rules have been made somewhat less unfriendly to poor countries coping with AIDS and other public health problems, but the TRIPs arrangement still reflects much more the interests of rich-country producers of innovations relative to poor-country consumers. Then there is the case of anti-dumping. A few of the bigger teams have players who are prepared to interrupt the game (crying injury!) when they are beginning to lose their advantage. Smaller teams are learning the trick too, but will never have the same resources to make their interruptions stick.<sup>4</sup>

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<sup>3</sup> Referring to unfair interpretation of trade rules, then-President Jorge Quiroga of Bolivia said in a 2002 speech at the Center for Global Development: 'We were out of shape, high deficits, ... high tariffs ... We got in shape. ... we start practicing ... So we come in and score a goal with our foot and they say 'No, no, you can't do that, you can only score with your head'. And we're not very tall to begin with, so it's kind of tough ... Then we score a goal from 18 yards away and they say, 'No, no, you can only score from 35 yards away' ... huge agricultural subsidies that keep you out .... And if you have a good midfielder, oops, red card, antidumping, he's selling too much, take him out'.

<sup>4</sup> At some point the owners may have to tighten up the injury rule if they want to preserve the integrity of the game.

In this note, however, I do not focus on the unfair rules and their imperfect interpretation and implementation (though that subject merits considerable discussion in itself).<sup>5</sup> Instead I concentrate on two more subtle shortcomings of open global markets for the poor. I state them here, continuing with the sports league metaphor, and in two subsequent sections discuss and document them.

First, openness in open global markets does not necessarily lead countries to grow (and growth is necessary if not always sufficient for reducing poverty). Like sports teams, countries without the right equipment are in trouble from the start—even on a perfectly level playing field with fair rules fairly implemented. Countries highly dependent on primary commodity exports two decades ago provide a convincing example. Their particular training and equipment, in retrospect, seems to have condemned them to the lowest division in the globalization league.

Second, for weaker teams with the wrong equipment and inadequate training, openness may actually be dangerous. For them bumps in the level playing field (market failures/negative externalities) are hard to handle. The example in this case is that of emerging market economies that entered this latest globalization era with high debt. For them, a stormy day or a rough soccer field can easily provoke a ruined pass or a twisted ankle. Among their players, those with less training and experience, like the poor in growing but volatile emerging markets, are vulnerable to injuries that can handicap them permanently.

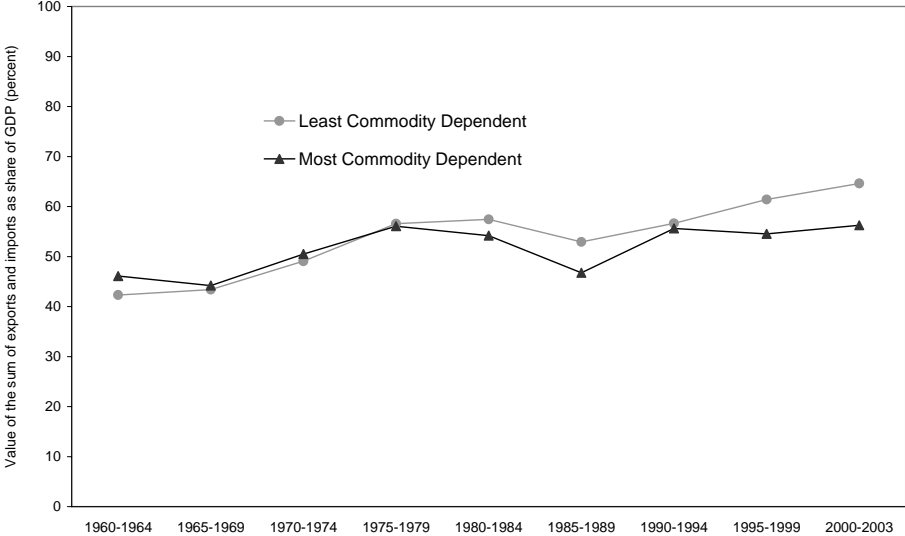
## **2 Openness does not necessarily lead to growth**

Consider the situation of many of the world's poorest countries, including most of the poor countries of sub-Saharan Africa. Many are highly dependent on primary commodity and natural resource exports. In Birdsall and Hamoudi (2002), we define a group of countries in terms of the composition of their exports in the early 1980s, when the terms of trade for commodity exporters were in the early stages of a subsequent long decline. Using data on exports for 115 developing and 22 developed countries for each year between 1980-84, we classified all exports (except those in SITC 9 'unspecified' products) as primary commodities or manufactures. For each country in each year we then calculated the share of primary commodities in total (specified) exports. Developing countries that fell into the top third of primary commodity exporters for at least four of the five years we labeled as 'most commodity dependent' (34 countries), and those that fell into that category for zero or one year we labeled as 'least commodity dependent' (72 countries). All the developing countries were in fact highly commodity dependent, with the average share of primary commodities in total exports for the least and most commodity dependent groups at 62 and 98 per cent respectively. More to the

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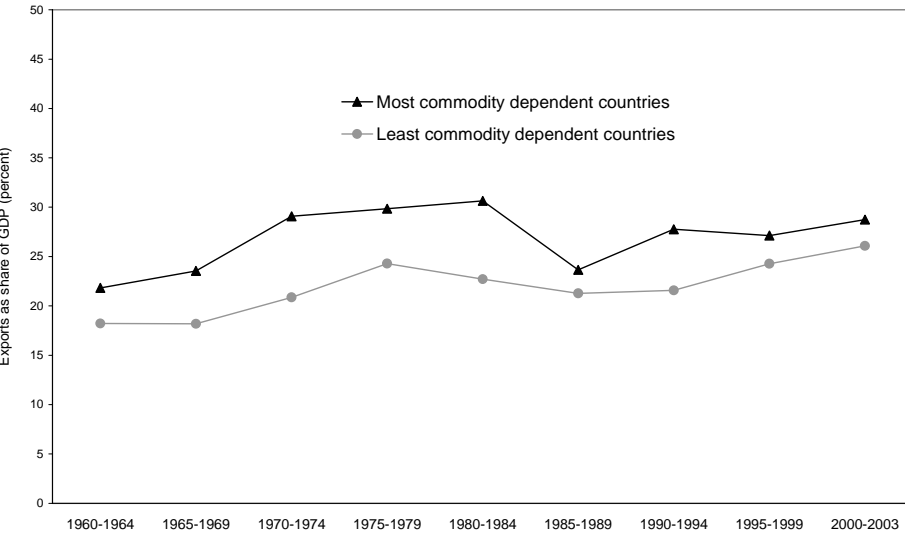
<sup>5</sup> See UNDP (2005).

Figure 1a: The 'most commodity dependent' countries have participated in global trade since the 1960s: trade to GDP ratios



Notes: Indicates the simple unweighted average ratio of the value of the sum of exports and imports to GDP for the "most commodity dependent" and "least commodity dependent" countries between 1960 and 2003. The "most commodity dependent" and "least commodity dependent" countries are as defined in table 2 of Birdsall and Hamoudi (2002). There are 72 "least commodity dependent" countries and 34 "most commodity dependent" countries. Sources: World Development Indicators (2005) and author's calculations.

Figure 1b: The 'most commodity dependent' countries have participated in global trade since the 1960s: exports to GDP ratios



Notes: Indicates the simple unweighted average ratio of the value of exports to GDP for the "most commodity dependent" and "least commodity dependent" countries between 1960 and 2003. The "most commodity dependent" and "least commodity dependent" countries are as defined in table 2 of Birdsall and Hamoudi (2002). There are 72 "least commodity dependent" countries and 34 "most commodity dependent" countries. Sources: World Development Indicators (2005) and author's calculations.

point of this paper, the most commodity dependent countries (defined as of the early 1980s) have not been any more reticent than the least commodity dependent countries about participating in international trade. They:

- generally traded as much as countries in the category of ‘least commodity dependent’ between 1960-80, if the level of trade is measured in terms of the ratio of exports plus imports to GDP (Figure 1a);<sup>6</sup>
- continued to participate in global markets in the period 1980-2003 by this definition, and have had a higher export/GDP ratio than the ‘least commodity dependent’ countries for the entire period 1960-2003 (Figure 1b);
- have been nearly as open from a policy point of view as the ‘least commodity dependent’ group.<sup>7</sup> For example, their tariff rates have been comparable to the rates of the least commodity dependent group. For countries in the two groups for which we have data on tariff rates, the most commodity dependent group cut their tariffs from an average of 25 per cent in the late 1980s to 18 per cent in the late 1990s; the least commodity dependent countries cut their tariffs from almost 26 per cent to 15 per cent, so they have had only slightly lower rates (see Table 1).<sup>8 9</sup>

But despite their substantial engagement in trade and the decline in their tariff rates, the most commodity dependent countries have failed to grow, especially after 1980. They grew at lower rates than the least commodity dependent group in the 1970s and 1980s, and have not grown at all since 1980 (Table 2).

What happened? The countries that were most commodity dependent in the early 1980s entered that decade as relatively successful exporters of goods whose relative prices had

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<sup>6</sup> Our group of most commodity-dependent countries overlaps closely with the ‘non-globalizers’ in Dollar and Kraay’s now well-known classification, as shown in Appendix Table 1 (see Dollar and Kraay 2001). The only ‘globalizers’ in our commodity-dependent group are Mali and Rwanda. Their ‘non-globalizers’ were in fact, like our set of commodity-dependent countries, ‘open’ in the early 1980s. However, their ‘non-globalizers’ are defined not in terms of countries’ levels of openness but in terms of their change in openness in the subsequent two decades. Non-globalizers are those where ‘openness’ did not increase in the last two decades (in comparison to globalizers where ‘openness’ did increase). Appendix Figures 1 and 2 compare the initial levels and trends using the two classifications.

<sup>7</sup> It is worth making a distinction between trade policies and what could be called ‘trade infrastructure.’ Winters (2001) notes that low tariff rates are misleading if they are unevenly and artificially applied as in Uganda in the 1980’s when there was dire conflict and considerable corruption by border and customs officials. But these kinds of barriers usually reflect not ‘trade policy’ or any policy intent, but poor governance and a weak state in general, leading to inadequate ‘trade infrastructure’, best thought of as a result of (endogenous to) a country’s poverty and lack of growth. See Rodriguez and Rodrik (1999).

<sup>8</sup> Equivalent tariff rates do not imply equivalent protection, as Clemens and Williamson (2004) note, across time or countries, and need not generate equivalent growth effects. Countries that export mostly commodities and import mostly manufactures face a higher cost of capital and lower effective investment rates, which will affect growth (Hsieh and Klenow 2002; Jones 1994).

<sup>9</sup> The standard deviations in Table 1 suggest there is no marked difference between the two groups in the variances of their rates. The more commodity dependent countries do not protect their industrial products more; their protection of these products in the late 1990s was only slightly higher in the most commodity dependent group. Average industrial and agricultural tariffs by country available from the World Bank, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20103740~menuPK:167374~pagePK:148956~piPK:216618~theSitePK:239071,00.html>.

Table 1: The 'most commodity dependent' countries have not eschewed global trade

<b>Average Tariff Rates</b> (unweighted, in percent)			
		Least Commodity Dependent Countries	Most Commodity Dependent Countries
<b>1986-1989</b>	mean	26	25
	median	19	27
	standard deviation (across countries)	19	12
	N	50	26
<b>1996-1999</b>	mean	15	18
	median	14	15
	standard deviation (across countries)	7	9
	N	50	26

Source: World Bank (2006) "Trends in Average Tariff Rates for Developing and Industrial Countries," available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20103740~menuPK:167374~pagePK:148956~piPK:216618~theSitePK:239071,00.html>

Table 2: The 'most commodity dependent countries' have not grown

<b>Average Annual Rate of Growth of Real PPP Adjusted GDP Per Capita</b> (percent)			
		Least Commodity Dependent Countries	Most Commodity Dependent Countries
<b>Growth During the 1980s</b>	mean	1.1	-0.09
	median	0.5	-1.3
	25th percentile	-0.7	-2.4
	75th percentile	3.0	0.4
	N	65	32
<b>Growth During the 1990s</b>	mean	1.5	0.0
	median	1.7	0.4
	25th percentile	0.0	-1.6
	75th percentile	3.2	1.6
	N	68	28

Notes:

All statistics are unweighted.

The classification of countries is as shown in table 2 of Birdsall and Hamoudi (2002).

Average annual rates of growth of real PPP adjusted GDP per capita during the 1980s and during the 1990s are taken from the dataset underlying Dollar and Kraay (2001), which the authors were generous to share. The samples do not include all 34 "most commodity dependent" and 72 "least commodity dependent" countries because some countries had to be dropped due to the lack of income data. These data on growth rates are far from perfect, though the overall differences between the two groups are sufficient to buttress the point. The low growth rates reflect the arithmetic influence of many slow-growing (but small) countries, and so are lower than population-weighted averages would be.

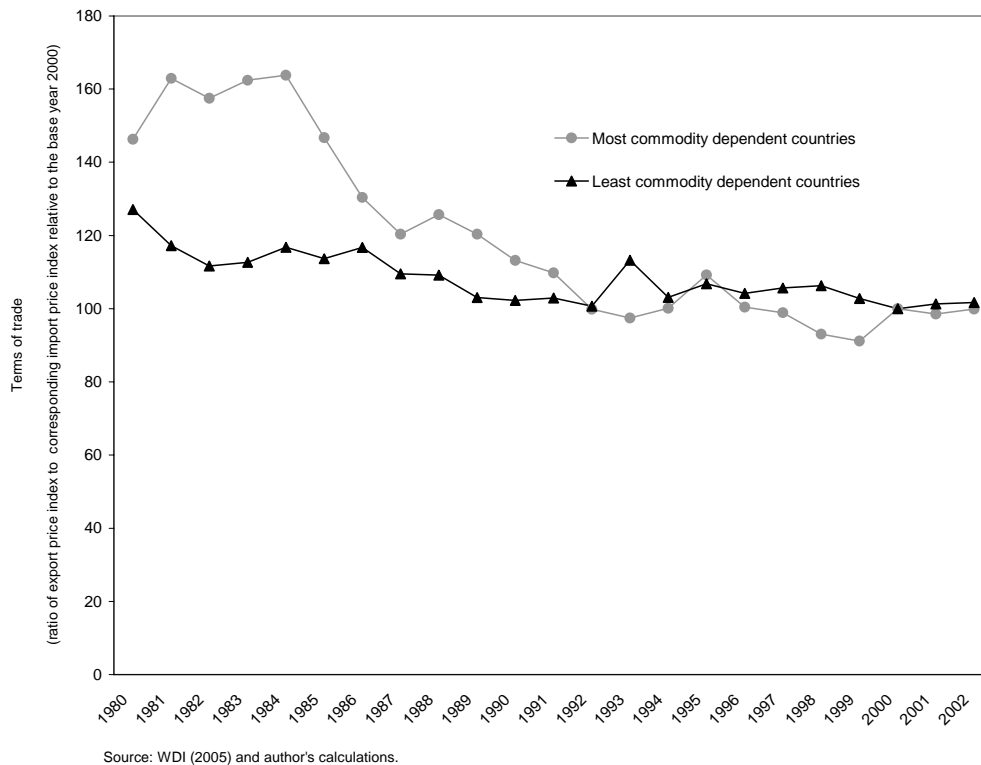
Source: Birdsall and Hamoudi (2002).

been steady in the 1960s increased rapidly during the 1970s and then declined dramatically in the 1980s. In the 1980s, when the prices of their principal exports began to decline, their export revenue and capacity to import fell. Despite the large decline in their terms of trade, almost 30 per cent in the most commodity dependent countries



from 1980-90 to 1991-2002 and nearly 8 per cent for the least commodity dependent countries (Figure 2), they for the most part failed to diversify their exports. The problem may have been that producers and investors believed that relative prices would recover. One result is that imports as a proportion of GDP (which was itself not growing, see Table 2) never rose (Figure 3).

Figure 2: The terms of trade of commodity producing countries have declined since the early 1980s



For countries highly dependent on commodities for export income the problem of declining terms of trade persisted in the 1990s. For example, declines in cotton prices (and increases in oil prices) hurt Mali (Figure 4), and in Ethiopia an increasing volume of coffee exports failed to compensate for declining prices (Figure 5). Diversification of exports is obviously key for these countries, but their infrastructure, governance, human capital and overall institutional setting are not propitious for diversification.<sup>10</sup> Whatever the reason, the fact remains that these countries have been ‘open’ for more than two decades—in the sense that they have been clearly engaged in global markets, and have reduced their own tariff rates. But with the value of their exports stagnating over the past two decades, their capacity to increase imports has been constrained. As a result, the amount of trade that occurs between these countries and the rest of the world has failed to increase relative to their GDP.

<sup>10</sup> Rodrik (1999) shows the relevance of institutions to growth—in contrast to any simple relation between trade policy and growth—and discusses the implications for the global governance of trade (Rodrik 2001).

Figure 3: Trade ratios in the most commodity dependent countries

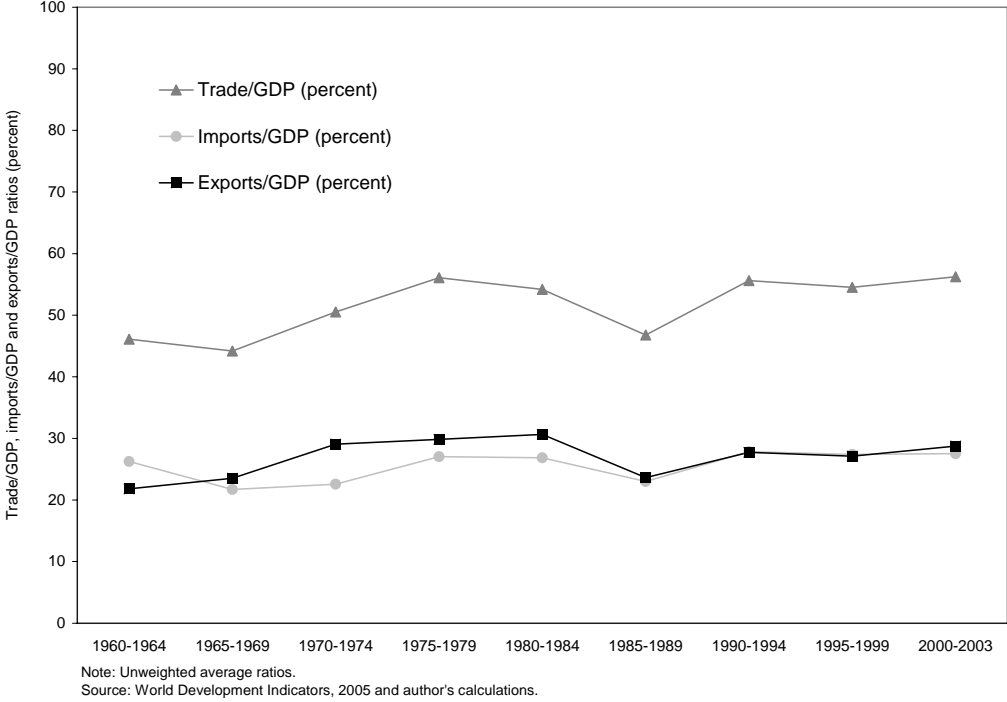


Figure 4: In Mali, the value of cotton exports declined while the value of oil imports rose

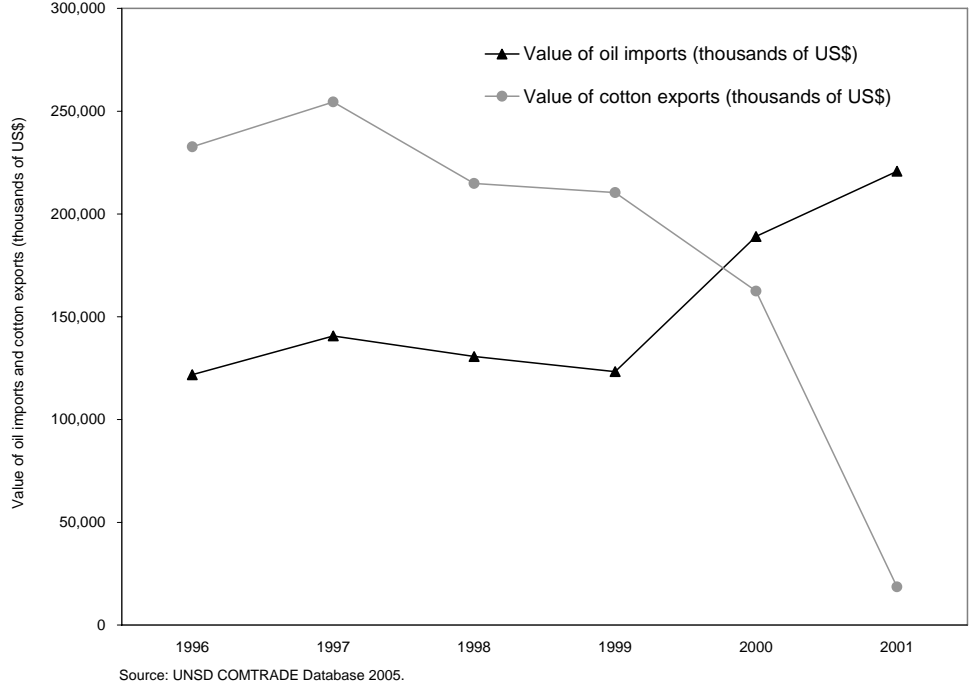
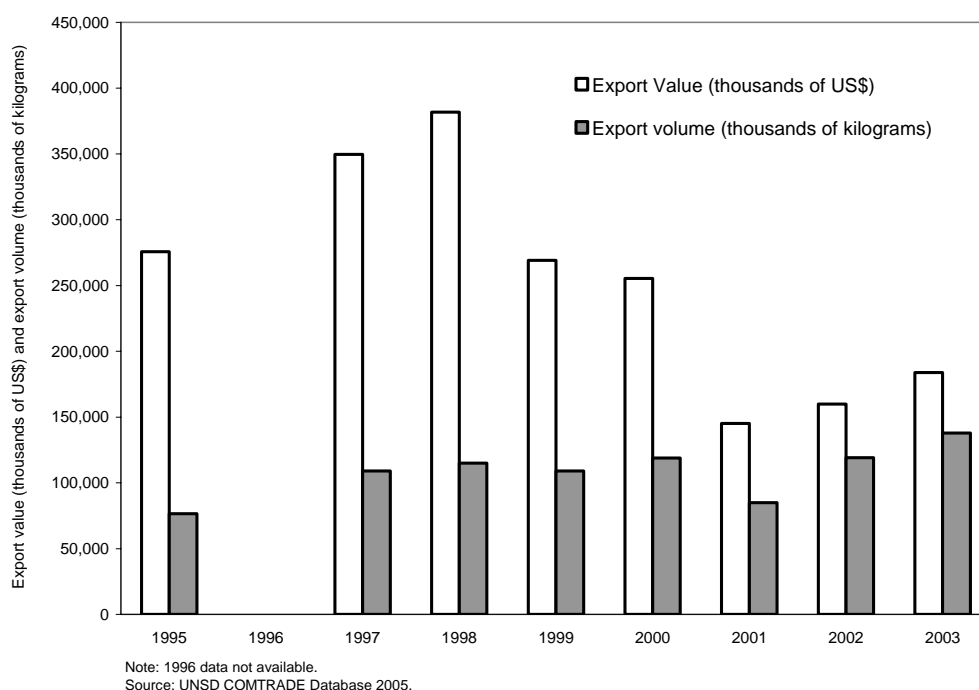


Figure 5: Coffee exports rise but the value of coffee exports falls in Ethiopia



In short, their initial and continuing relatively high degree of openness has not bought them subsequent healthy rates of growth. Their lack of growth is apparently due to factors that have little to do with whether they are open, and much to do with other factors associated with their continuing dependence on commodity exports.<sup>11</sup> In addition to the direct fiscal and import constraints, it seems likely that they are trapped in some sort of bad equilibrium, in which commodity dependence is associated with institutional failures that have made escape from commodity dependence difficult.<sup>12</sup> In settings where initial political and economic institutions are relatively weak, production based on natural resources appears to encourage predatory government behaviour and rent-seeking and to discourage development of the predictable, stable, democratic institutions that are conducive to growth. It also provides poor incentives for human capital investment, and discourages learning by doing, knowledge spillovers and increasing use of technology, at least compared to production of manufactured goods.<sup>13</sup>

<sup>11</sup> Most of these countries in the late 1990s still had more than 80 per cent of their exports being commodities (WTO Trade Database, see <http://stat.wto.org/StatisticalProgram/WSDDBStatProgramHome.aspx?Language=E>).

<sup>12</sup> Highly commodity dependent countries' difficulty in increasing their trade share may itself be bad for their governance. Krueger (1990) suggested that openness is likely to reduce rent-seeking; Ades and di Tilla (1999) show that a higher ratio of imports to GDP is associated with less corruption, and that a high proportion of fuels and minerals in exports is associated with more corruption. Wei (2000) shows that countries that are 'naturally open', including due to good geography, have better government institutions; corruption is negatively correlated with the difference between actual and predicted openness.

<sup>13</sup> Birdsall and Hamoudi (2002) include a brief review of the relevant literature.

Of course there are other possible traps besides heavy dependence on commodity exports in the early 1980s (though they may well be highly correlated with and reinforced by such dependence).<sup>14</sup> Frankel and Romer (1999) present evidence of the effect of what might be called trade-enhancing geography (or conversely trade-reducing geography) on growth, including the effects of country size (small size is bad for growth) and landlocked status (bad). The impact of trade-enhancing geography on growth is large and positive, perhaps because good geography enhances not only trade itself but also other ‘income-enhancing interactions’ such as the spread of ideas.

To return to the sports metaphor, success in global markets depends on arriving at the game with the right equipment and training. Most of the countries with a comparative advantage in primary goods in the early 1980s (unless they already had developed good institutions) have not done well—no matter how open they have been—on the level playing field.<sup>15</sup> At least for the last two decades, their resources have turned out to provide the wrong equipment for the globalization game.<sup>16</sup> This does not imply that these countries would have been better off with more protectionism—only that lack of policy openness is not necessarily the key constraint to their future growth.<sup>17</sup>

## **2.1 Openness can be dangerous for the poor**

Developing countries have had lower overall growth and higher volatility of growth rates compared to advanced economies in every decade including and since the 1960s.<sup>18</sup> There seems little questions that the deeper financial integration, greater trade diversification, and more effective macroeconomic management in the latter group all contribute to lower volatility. For example, a deep domestic financial sector though not

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<sup>14</sup> Recent calls for a doubling of aid to Africa have been based in part on the need for a ‘big push’ of new investments on multiple fronts (health, education, agriculture, infrastructure), to enable countries to escape the poverty trap, harking back to the ideas of Rostow (1960); see Sachs (2004), UN (2004). Easterly (2005) and Kraay and Raddatz (2005) present historical and other evidence inconsistent with the existence of poverty traps.

<sup>15</sup> This is obviously not true for all commodity dependent countries—Botswana, Chile, and Indonesia have had high average growth rates since 1980. But it does appear to be true for our ‘most’ commodity dependent countries—those for which in the early 1980s more than 90 per cent of exports were primary commodities.

<sup>16</sup> Moreover their failure to grow has apparently made it tough to acquire better equipment. This is the case even though some of the poorest countries have been receiving net annual transfers amounting to as much as 10 per cent of their GDP. Even discounting the value of net transfers to take into account that much of the aid has been tied and has come in the unco-ordinated and sometimes unpredictable form of multiple projects financed by multiple donors, the failure to grow suggests that institutional problems have been paramount, and that dependence on commodity exports, if it has constrained growth, has done so for reasons beyond its disadvantages from a financial point of view.

<sup>17</sup> On this particular point, see Birdsall et al. (2005), who suggest that lack of infrastructure and other domestic factors are likely to limit the benefits of agricultural and other Doha-negotiated liberalizations, at least in the short run, for many poor countries.

<sup>18</sup> See Kose et al. (2004: table 1). Easterly et al. (2000) report that growth volatility in developing countries was twice that in OECD economies in the periods 1960-78 and 1979-97.

causally linked to growth (Prasad et al. 2004), is associated with reduced growth volatility (Frankel and Cavallo 2004). But that is the case mainly for developed economies; indicators of financial depth such as the ratio of credit to the private sector to GDP are much lower in developing countries (25 per cent in the Easterly et al. (2000) sample, compared to 64 per cent). Indeed volatility can be thought of in general as a natural outcome of the less effective institutions that distinguish developing countries from their more advanced and richer counterparts. Similarly with trade integration, there is some evidence that though greater trade integration reduces volatility on average across all countries that is not true or is at least is less the case for developing economies (Easterly et al. 2000).<sup>19</sup>

The key point I want to emphasize, however, is that open markets, especially open capital markets, can be associated with greater volatility, and the resulting volatility is bad for the poor *within* countries. That open markets may increase volatility is almost certainly due to the interaction of openness with the institutional and policy shortcomings referred to above. Thus though openness is dangerous for the poor within countries, the solution is not necessarily to reduce openness itself but to address the other shortcomings which, interacting with openness attenuate or even reverse its benefits for the poor.

#### *Volatility and the poor*

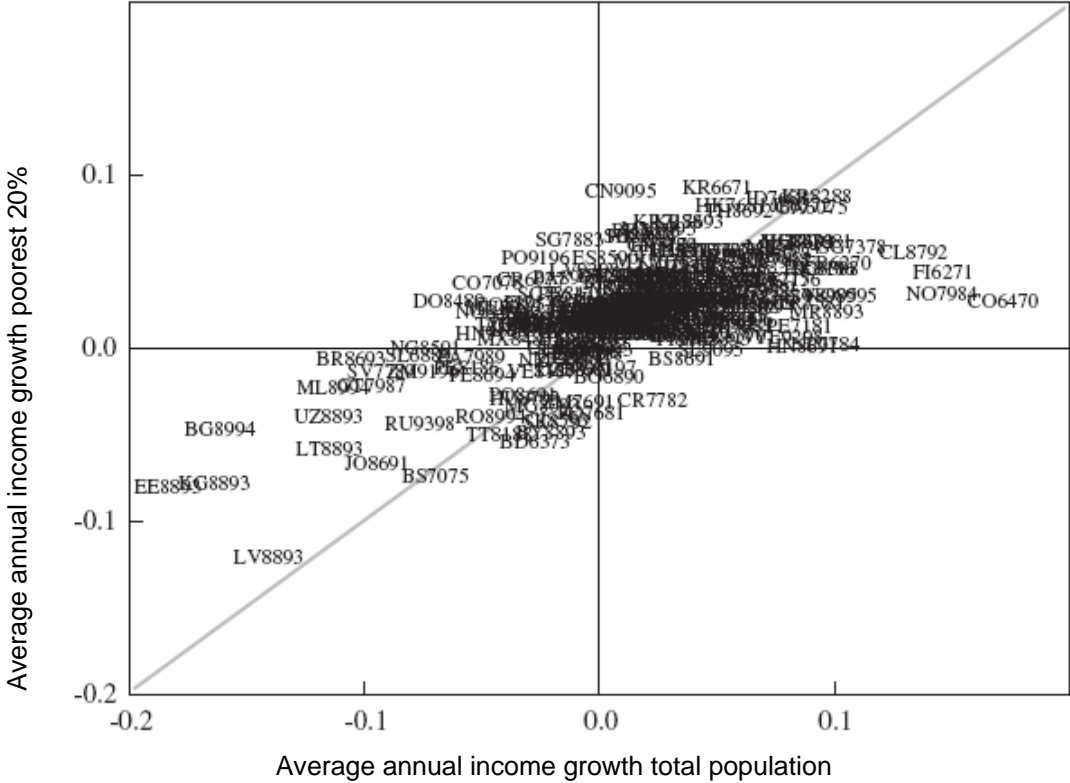
Figure 6 uses data from Dollar and Kraay (2001) to plot the annual growth rate of the poor on the average annual overall per capita growth rate for a sample of developing countries during various growth spells. It suggests that growth is indeed shared proportionately by the poor. Figure 7 shows the results of using the same data to regress the income growth of the bottom quintile on overall growth, but adding an interaction term to distinguish the effect of contractions on the poor from the effect of expansions. The slope of the best-fit line in the southwest quadrant is about 1.6; in the northeast quadrant, it is about 0.8. Though expansions are good for the poor, contractions are more than proportionately bad for them.<sup>20</sup> This suggests an important qualification to Dollar and Kraay's findings about the *general* relationship between average growth and

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<sup>19</sup> Kose et al. (2004) report a mitigating effect of 'trade integration' on the negative effect of volatility on growth, but they use the Sachs-Warner measure of 'trade integration,' which incorporates measures that reflect institutional and macro management problems (such as the black market premium), which are not necessarily directly controlled by policymakers, especially in the short run.

<sup>20</sup> This is the case within countries independent of the absolute level of income of the poor—which is much higher in Poland, for example, than in most countries of sub-Saharan Africa.

Figure 6: On average, economic growth is probably being distributed proportionately across income groups



Note: Data on average annual income growth of the total population and average annual income growth of the poorest quintile. The 45-degree line is drawn for reference.

Source: Reproduced using data from Dollar and Kraay (2001).

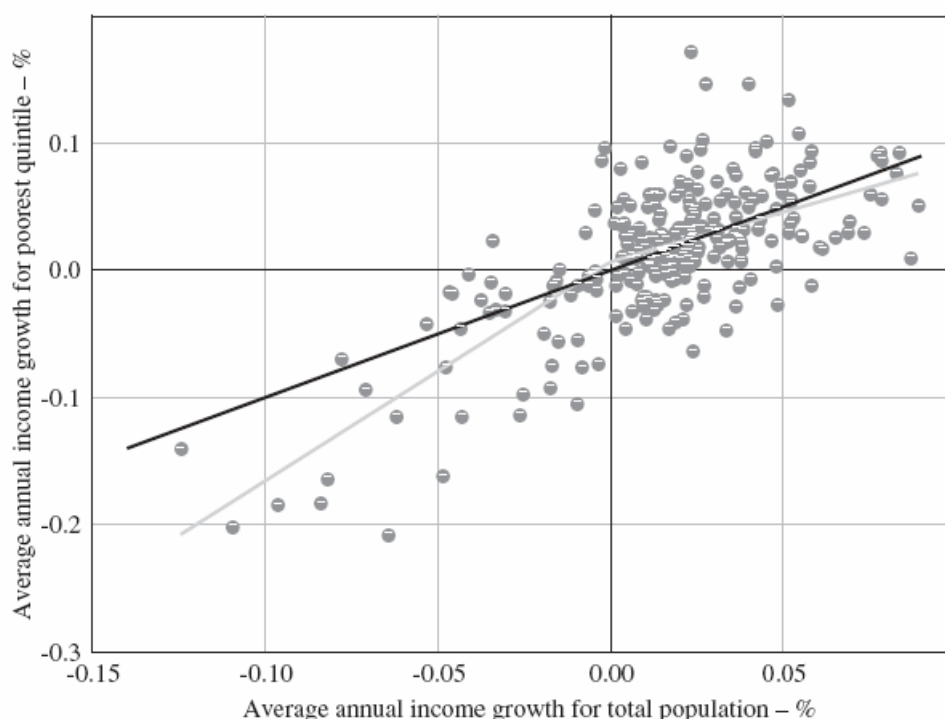
the share of the poor.<sup>21</sup> Of course, we must be mindful of the fact that the countries and time periods in the southwest quadrant are different from the countries and time periods in the northeast quadrant,<sup>22</sup> and it may be that contractions and expansions in different places have very different effects on the poor. The observations in the southwest quadrant include negative growth spells in transition economies of Eastern Europe and the former Soviet Union, but also spells in Mali, Peru, Brazil, Guatemala, Zambia, Jordan, Mexico, Honduras, Nigeria, and others.

Consistent with the possibility that openness, because it increases the likelihood of volatility, may indirectly hurt the poor within developing countries, Lundberg and Squire (2003), using country data on changes in income for different quintiles of the

<sup>21</sup> Similarly, a regression of the average annual proportional change in the poverty headcount against average annual income growth (along the lines of Ravallion 2001) indicates that the effects of contractions increase the number of poor more than the effects of expansions increase their numbers. The poverty headcount is about twice as sensitive to income contractions as it is to income expansions, though that may simply reflect the larger number of people above compared to below the poverty line (in, for example, a lognormal distribution of income).

<sup>22</sup> In addition, the ‘poor’ at the beginning and end of each spell need not be the same people.

Figure 7: But *contractions* may take disproportionately from the poor



Notes: Graphical representation of the results of a regression of income growth in the total population against income growth in the poorest quintile, with an interaction term to allow for differential effects of contractions as opposed to expansions. The regression includes 258 observations, and produces an R-squared of 0.54; the coefficient on average income growth is 0.78 (s.e. 0.12), plus an additional 0.94 (s.e. 0.24) in times of contraction. The intercept term is nearly at the origin (0.006, s.e. 0.004). The standard errors given use the Huber/White/Sandwich estimator of the variance in order to be robust to heteroskedasticity, but are not corrected for possible serial correlation. The coefficient on income in times of contraction is significantly greater than one, implying that there may be a systematic correlation between contractions in average income and declines in the income share of the poorest quintile. The 45-degree line is drawn (solid black line) for reference.

Source: Birdsall and Hamoudi (2002).

income distribution, report that the negative consequences of terms of trade changes are ‘far greater’ for the poorest 40 per cent than for the middle 60 per cent and wealthiest 40 per cent of households (overlapping groups), with that vulnerability exacerbated by a country’s openness.<sup>23 24</sup>

<sup>23</sup> Lundberg and Squire (2003) also conclude that the costs of adjusting to ‘openness’ have been borne ‘*exclusively*’ (their italics) by the poorest 40 per cent of households. Their results are suggestive but not definitive since they use the Sachs-Warner index of openness, which includes country characteristics such as the black market premium that reflect outcomes of many policies and not just of trade policy itself.

<sup>24</sup> Of course we cannot be sure that the right counterfactual is not a closed economy growing so slowly or not growing at all that would make the poor even worse off. Technically, one could make the following argument about variability and volatility. If the marginal utility of consumption is higher at low income levels, as we expect, then the change in utility from a given degree in volatility will be more severe for the poor than for the non-poor. So there is some amount of sacrifice in the plateau of average income that could be made in exchange for reduced volatility that would leave the utility of the poor unchanged. The question is whether openness increases growth enough that this tradeoff is unattractive, because the sacrifice in average income from closedness is greater than the amount that just offsets the utility loss from greater volatility. I am grateful to Bill Cline for elaborating on this point.

### *Volatility, capital markets and the poor*

The global financial crises of the 1990s were only the most recent in a long history of financial bubbles that have burst. Financial crises are not special to poor and emerging markets; but the crises of the last decade suggest that whether induced by domestic policy problems or global contagion (or the combustible mix of both), the same crisis can be more costly for relatively poorer countries, if only because their local financial markets are thinner and less resilient and local and foreign creditors more skittish than in deeper markets.<sup>25</sup> Indeed one of the ironies of globalization may be that emerging market economies, if they are to exploit the benefits of a global market, simply cannot afford the policy errors and institutional weaknesses that are characteristic of being ‘emerging’.

Despite those risks, the trend among developing countries over the past three decades has been toward greater capital market openness; the number of developing countries declaring their currencies convertible on capital account transactions increased from 34 (30 per cent of IMF member countries) to 143 (77 per cent) between 1970-97.<sup>26</sup> It makes sense for countries that are capital-scarce to open their capital accounts, and in principle an open capital account could make it easier for a country to manage shocks. On the other hand, an open capital account in good times invites inflow surges creating pressure on exchange rates that can hurt exports and/or if sterilized, keep interest rates high. In bad times there is the risk of panicked outflows over which authorities have little control—for example because of a liquidity crisis provoked elsewhere in the global market.<sup>27</sup> In some emerging market economies, resulting crises have led to an accumulation of debt, higher interest rates (reducing investment and growth), and the risk of future self-fulfilling losses of confidence.<sup>28</sup> The problem for the poor is compounded because to restore confidence, emerging markets are forced to abstain from otherwise sensible countercyclical fiscal and monetary policy—and therefore have difficulty sustaining a social safety net to protect the poor during downturns.<sup>29</sup>

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<sup>25</sup> Countries with a history of inflation, as is the case in the emerging market economies of Latin America, have the particularly grim problem that their bad history leads the markets to demand procyclical fiscal austerity during crises.

<sup>26</sup> Dailami and ul Haque (1998).

<sup>27</sup> High inflows can also create dangerous asset bubbles etc. The crisis in Russia in 1998 precipitated the crisis in Brazil that led to Brazil’s devaluation of the real—in turn contributing to Argentina’s crisis (by undermining the latter’s export competitiveness). Chile-type disincentives to restrain short-term capital inflows, along with high reserves to protect economies during global crises can help, but these also imply costs to emerging markets that the ‘emerged’ economies need not bear.

<sup>28</sup> Rojas-Suarez (2005) notes that the ratio of deposits to GDP remained highly volatile in developing countries in the 1990s, (her table 1), along with high real interest rates (her table 2), reflecting investors’ concerns.

<sup>29</sup> Dervis and Birdsall (forthcoming) propose a new facility at the IMF or the multilateral banks, among other things, to help address the problem of high-debt emerging market economies finding it difficult to sustain social spending during downturns.



We cannot conclude that openness is a principal cause of volatility, and certainly not that closing trade markets and the capital account would in themselves reduce volatility or increase growth. Indeed growth in the developing world could well have been even lower than it has been with less open trade and capital markets (though China and India have remained relatively closed they are large enough economies to have large internal markets). But neither can we deny that with greater average dependence on exports whose prices are volatile and on domestic financial sectors that are smaller and less resilient, openness poses greater risks than it does for the richer economies, and is particularly risky for the poor within developing countries, increasing the risks of negative growth spells and compounding the difficulty of managing a countercyclical social safety net.<sup>30</sup>

## 2.2 Open capital markets and inequality

An additional problem is that open capital markets may not only slow poverty reduction, but contribute to an increase in the concentration of income within developing countries, i.e. increasing the income gap between the rich and other households. To the extent that open capital markets contribute to income concentration, they may indirectly reduce growth. That is because in developing countries inequality of income combined with weak capital markets appears to reduce growth, and may contribute to social and ethnic tensions that make good management of the economy politically difficult.<sup>31</sup>

Why would open capital markets be associated with income inequality? Theory, after all, predicts the opposite—that better access to capital would reduce the domestic return to capital relative to the return to labour. One explanation may be that capital and skilled labour are complementary, so that increased access to capital raises the returns to highly skilled labour and increases the wage gap between the skilled and unskilled. Behrman et al. (2002) report dramatic increases in the return to higher (post-secondary) education in most countries of Latin America, especially compared to secondary education. They test the effects of various liberalizing economic reforms on the wage differential between the skilled and unskilled, using household survey data combined with country

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<sup>30</sup> Regressions of spells of income growth for the poorest quintile across countries in the 1990s, on the openness of countries' capital account and other standard variables suggested no obvious association between capital openness and the changing income shares of the poor. However the measure of countries' capital openness, available from the IMF, exists for only a single year late in the 1990s; there is no measure that I could find of the change in capital openness. And the measure used is probably crude. There has been much less effort to quantify openness of the capital account than of the trade regime.

<sup>31</sup> For evidence that income inequality reduces growth in developing countries though not in developed countries (presumably because government and market failures are lesser in the latter), see Barro (2000). Birdsall (2001) discusses why inequality matters. Birdsall and Londono (1997) emphasize that it is asset inequality not necessarily income inequality itself which is associated with low growth; they show that inequality of education and of land are associated with reduced growth across countries. See also Deininger and Olinto (2000). Aghion et al. (2000) suggest how unequal access to credit markets can reduce aggregate investment returns.

and year-specific indices of policy, across 28 countries of Latin America over several decades.<sup>32</sup> Their results indicate that capital account liberalization (and domestic financial market liberalization) are associated with an increase in the wage differential which is substantial for several years and then diminishes.<sup>33</sup> This market-led effect is not small, but in principle it should increase the demand for higher education as an equilibrating mechanism, and indeed that may be happening in Latin America and worldwide.<sup>34</sup>

More disturbing is the evidence of more patently non-market and ‘unfair’ disadvantages for lower income groups associated with open capital markets. In Turkey, Argentina and Mexico, with repeated bouts of inflation and currency devaluations in the last two decades, the ability of those with more financial assets to move those assets abroad, often simultaneously acquiring bank and corporate debt that is then socialized and paid by taxpayers, has almost certainly increased inequality.<sup>35</sup> In East Asia, inequality of income increased (in Thailand and Malaysia and probably in Indonesia) during the boom years of high capital inflows in the mid 1990s; as portfolio inflows and high bank lending fuelled demand for assets such as land and stocks, inequality of wealth no doubt increased even more, though data on the distribution of wealth are not reliable (due mostly to underreporting) and many of those who accumulated wealth no doubt lost much of it when the crisis hit. Still, some evidence suggests that the lower middle and working classes in those countries were hit hardest by the crisis, especially in terms of lost employment,<sup>36</sup> and to the extent the poor also lost out, their losses in welfare terms would be particularly great. In addition there is the likelihood that the high interest rates to which the affected countries resorted to stabilize their currencies—both in East Asia and then in 1998-99 in Brazil—also had a redistributive effect, hurting most capital-starved enterprises and their low-wage employees.

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<sup>32</sup> They estimate differences in differences; the dependent variable is the difference between two survey points in the private rate of return to education for males aged 20 to 55. Their results demonstrate the relevance, and the limits, of Stolper-Samuelson.

<sup>33</sup> Other reforms, including trade liberalization and privatization have a zero (trade) or negative (i.e. beneficent, for privatization) effect. The short-term ‘bad’ effects of the financial and capital account variables are sufficient to ensure an overall ‘bad’ effect of an aggregate country and year-specific reform index. Morley (2001) report the opposite effect of more open capital markets for his urban and nationwide samples, but not for his, combined sample (nationwide plus urban sample). He reports a positive and statistically significant relationship between more open capital markets and equality. So there is no clear story—only some evidence that the textbook theory may not apply in all circumstances.

<sup>34</sup> Only if the distribution of education improves very rapidly, however, is it likely to outpace growing demand for the highly skilled. At least that is the record of recent decades: demand for the highly skilled has been outpacing supply, raising the relative returns to skills worldwide. Milanovic and Squire (2005) emphasize the resulting anomaly in developing countries, where globalization should favour their plentiful unskilled.

<sup>35</sup> Pfeffermann (2002) puts together the relevant pieces of data on crises and devaluations for Latin America, suggesting that if the rich can manage capital flight, they can exploit the crises.

<sup>36</sup> Birdsall and Haggard (2000) present evidence on this point. Consumption levels of these groups were mostly preserved, presumably by their using savings and otherwise reducing their assets.

Table 3: Financial crises and changes in income shares

	Pre-crisis		Post-crisis	
	Income share <i>poorest 80% of</i> population (percent)	Income share <i>richest 20% of</i> population (percent)	Income share <i>poorest 80% of</i> population (percent)	Income share <i>richest 20% of</i> population (percent)
Korea	61.2	38.8	58.3	41.7
Philippines	48.0	51.9	45.2	54.8
Thailand	39.2	60.8	38.2	61.8
Brazil	35.1	64.8	34.4	65.6
Mexico	42.0	58.0	41.5	58.5
	Income share <i>poorest 40% of</i> population (percent)	Income share <i>richest 20% of</i> population (percent)	Income share <i>poorest 40% of</i> population (percent)	Income share <i>richest 20% of</i> population (percent)
Korea	19.3	38.8	15.9	41.7
Philippines	13.7	51.9	12.3	54.8
Thailand	8.2	60.8	7.8	61.8
Brazil	8.2	64.8	8.0	65.6
Mexico	11.2	58.0	10.7	58.5

Note:

East Asian financial crisis 1997/1998, Brazil crisis 1999, and Mexico crisis 1994/1995.

Pre-crisis data for Thailand, Korea and Brazil are from 1996, for the Philippines from 1994 and Mexico 1992. Post-crisis data are from 1996 for Mexico, 1998 for Korea, 1999 for Thailand, 2000 for the Philippines, and 2001 for Brazil.

Source: WIDER WIID 2.0a and author's calculations.

Table 3 shows changes in the income shares of the richest 20 per cent of households and the 'other' 80 per cent pre and post crisis for selected countries. Given the fragility of the income data, the consistency of the changes is noteworthy. The richest 20 per cent may well lose in absolute terms during crises but they lose relatively less than the rest. The Gini coefficient, similarly, rose after financial crises in Korea, the Philippines, Thailand, Brazil and Mexico (Table 4). (Of course these before and after comparisons cannot establish causation.) Opening of the capital account is usually one aspect of liberalization of the domestic financial sector, which is also associated with reduction of the income share of the non-rich (Figure 8).

In addition, the bank bailouts that generally follow financial crises tend to create substantially more public debt relative to GDP in developing than in developed countries. Indonesia's 1998-99 financial crisis cost it an astonishing 45 per cent of GDP.<sup>37</sup> The cost of crises in developing countries is usually over 10 per cent of GDP compared to below 5 per cent in the OECD. The USA savings and loan crisis of the early 1990s cost an estimated 2-3 per cent of GDP (Norton 1997). The resulting high public debt in developing countries helps sustain high-income inequality, since public

<sup>37</sup> Author's calculations from *World Development Indicators Database* (2002).

Table 4: Financial crises and inequality

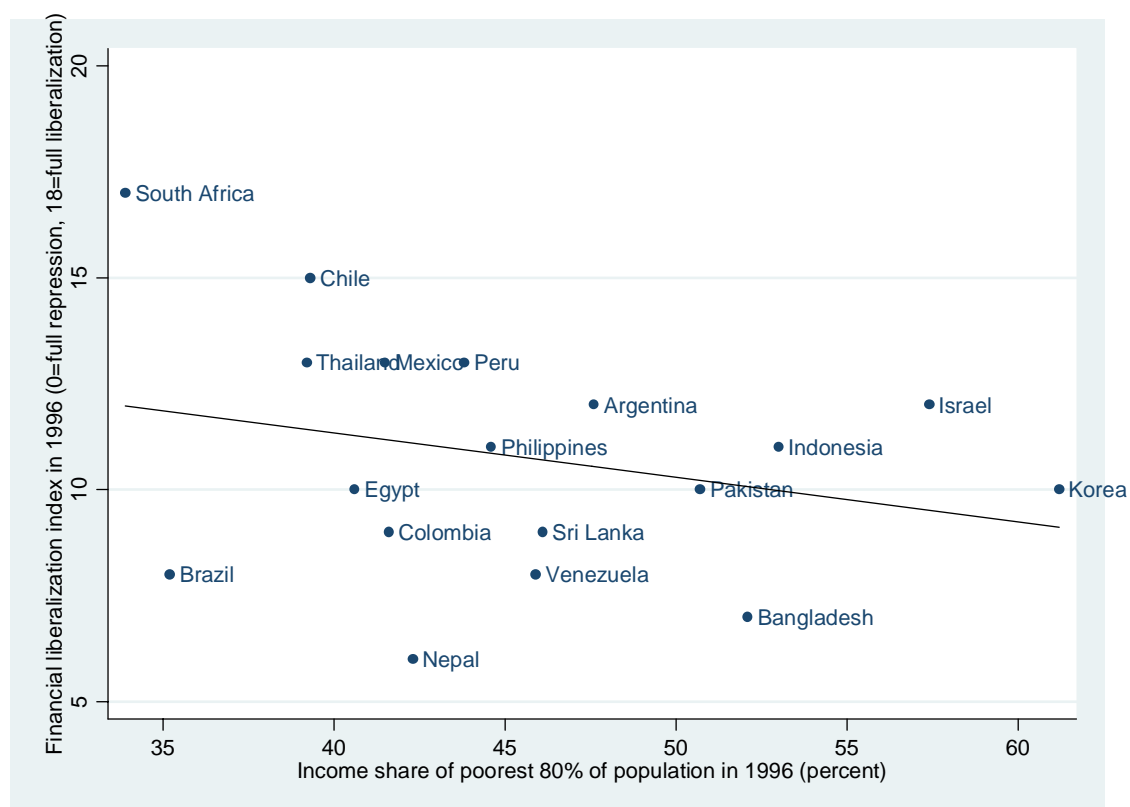
	Pre-crisis	Post-crisis
	Gini	Gini
Korea	32.6	37.2
Philippines	46.2	49.5
Thailand	57.5	58.5
Brazil	60.2	61.2
Mexico	52.9	53.7

East Asian financial crisis 1997/1998, Brazil crisis 1999, and Mexico crisis 1994/1995.

Pre-crisis data for Thailand, Korea and Brazil are from 1996, for the Philippines from 1994 and Mexico 1992. Post-crisis data are from 1996 for Mexico, 1998 for Korea, 1999 for Thailand, 2000 for the Philippines, and 2001 for Brazil.

Source: WIDER WIID 2.0a.

Figure 8: Financial liberalization and the income share of 'non-rich' 80 per cent of the population in 1996



Sources: Abiad et al. (2003), WIDER WIID 2.0a and author's calculations.

debt generally implies a transfer from taxpayers to rentiers.<sup>38</sup> Even when depositors are protected, the distributive effect is probably perverse, as long as depositors are on average from higher-income households than taxpayers. That seems a good possibility in many developing countries, since they tend to rely heavily on indirect trade taxes and the value-added tax, which are not progressive.<sup>39</sup> There is also the point that the poor benefit more from higher public expenditures, and the medium-term effect of the public financing of bailouts is to reduce public expenditures from whatever they might have been.<sup>40</sup>

Consistent with the story above, Diwan (2001) finds, using a panel of country data that the share of labour in GDP usually falls sharply following a financial crisis, and recovers only partially in subsequent years. He suggests that the declining labour share reflects not only the relatively automatic asymmetry in the effects of crises to which I have referred, but also a ‘change in the distribution rules’ with crises. If the state feels compelled to bail out the banking sector (to avoid a run on deposits and a collapse in output), it is likely to be labour that in the short run finances the bailout through reduced employment and real wage cuts.<sup>41</sup> With capital able to shield itself more easily from the costs of adjustment, labour takes the brunt of the adjustment. His results are also consistent with the apparent disproportionate effect of contractions on the income of the poor shown above, assuming there is a correlation between effects on the labour share and effects on the poor.

### **3 Implications**

That openness is not necessarily good for the poor does not imply that it is necessarily bad for the poor. Only that it all depends. It depends on the resolution of two existing asymmetries in the way the global economy operates. (In addition to these two asymmetries there is the problem that the powerful make and implement the rules, as the limited access of developing countries to certain rich country markets suggests. That problem, though politically difficult to fix, is conceptually straightforward, and even avid globaphiles agree that change is needed.)

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<sup>38</sup> In particular interest rate increases are assumed to hurt the poor more. Agénor et al. (forthcoming) simulate the effect of a 10 percentage point increase in the interest rate in a model of the Brazilian economy. Their results include increases in the poverty headcount and the Gini coefficient.

<sup>39</sup> Honohan (2005) notes that banking crises sometimes reduce income inequality because the rich suffer substantial losses. The exceptions he reports are in Latin America (where concentration of income is very high and the rich may be better able to protect their assets).

<sup>40</sup> Take the case of Argentina. The public sector assumed substantial debt in the early 1990s when the convertibility policy was introduced, and this reduced its ability to finance greater spending on social programmes throughout the decade; the same phenomenon is likely to repeat itself given the 2002 crisis.

<sup>41</sup> The trigger can be a loss in public sector creditworthiness with confidence in the value of deposits eroding, as in Argentina recently, or private sector losses which the public sector ends up having to assume, as during the East Asian crisis.

First, some teams are trying to play without the right equipment. On a level playing field, participation in the game by ill-equipped teams does not provide an equal opportunity to win. Open markets (a level playing field) naturally reward most those who are well equipped and trained—in economic terms those who already have the most productive assets. At the individual level, those with land, financial assets, and human capital naturally have a leg up. The analogue of these individual assets at the country level seems to be effective and stable political and social institutions, particularly deep financial markets—a characteristic still confined almost completely to the OECD economies. Countries that are already ahead, with deep financial markets, stable political systems, secure property rights, adequate banking supervision, reasonable public services, and so on, have a much higher probability of staying ahead. They are able not only to adjust and diversify their economies in the face of changing global opportunities, but to attract more local and foreign investment, better exploiting their own peoples' entrepreneurial energy and skills. Though it is true that, all other things the same, capital will flow to places where it is most scarce because those are the places where its return will be highest, and that therefore convergence in income across countries ought to happen, it is also true that all other things are not the same. Because they are not the same, as much as 80 per cent of all foreign investment occurs among the industrialized countries, and just 0.1 per cent of all USA foreign investment went to sub-Saharan Africa in 2001.<sup>42</sup>

Second, the global market is far from perfect. Its market failures create risks for all countries, but the risks are asymmetric—greater for the more vulnerable developing countries. The evidence is clear in their greater growth volatility, the higher cost to them of financial crises, and the special risk that their government and institutional failures will combine with weak markets to exacerbate and perpetuate high inequality.

These two asymmetries help explain the lack of convergence between the income and welfare of rich and poor countries in the last 50 years, and within many countries, between rich and poor individuals.<sup>43</sup> The status quo of the global economy does not produce the equal economic opportunities for all that would justify the mainstream view that the current global regime will more or less automatically bring growth and poverty reduction to everyone—if only all countries would get 'globalized.' Like domestic economies, the global economy needs the civilizing hand of appropriate intervention if we are to see a reduction in global poverty and increased income convergence across countries. What that appropriate intervention would be is too large and complex a topic to tackle here. But it would surely include more transfers from rich to poor countries than the current 0.3 per cent of the formers' combined GDPs (compared to transfers

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<sup>42</sup> UNCTAD (2001). A reader might ask: 'What about South Korea's convergence on Japan's income, and China's several decades of growth?' The answer is, I am describing a tendency, not a predictable, definitive, generalizable outcome.

<sup>43</sup> See Pritchett (1997).

from rich to poor in the USA more than 10 times as great), and more active management of such global problems as money laundering, tax evasion, sovereign bankruptcy, and capital flight, not to speak of global health and environmental issues. Because the market works and rewards more highly the more able and productive, the global economy would be enriched in the long run by a global social contract that financed equal opportunity investments in the initially weak and disadvantaged.<sup>44</sup> And because the global market is ridden with the usual market failures, we need global arrangements that, via some mechanisms equivalent to the usual taxes, subsidies, and regulatory arrangements we have in modern capitalist economies, reduce the difference between individual country returns and the social return to the global economy and all its players.

Thus the discussion of whether globalization and openness are good or bad for the poor should move on to a discussion of the appropriate global social contract and appropriate global arrangements for minimizing the asymmetric risks and costs of global market failures.

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<sup>44</sup> Thus we have such institutions as the World Bank and bilateral development assistance programmes. They tend to operate more in the spirit of charity, however, than as part of a global social contract in which both 'sides' benefit.

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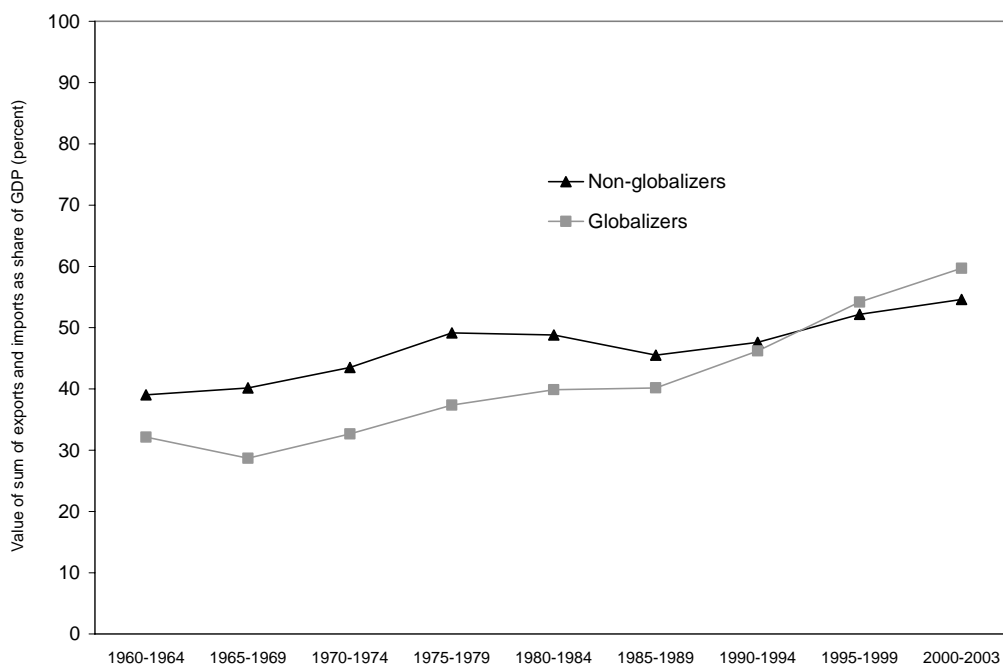
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Appendix Table A1: Definitions of country groups

	Least Commodity Dependent (1980-84)	Most Commodity Dependent (1980-84)	Neither most nor least commodity dependent
Non-globalizers	Benin; Burkina Faso; Egypt; El Salvador; Fiji; Guatemala; Honduras; Indonesia; Israel; Kenya; Madagascar; Mauritius; Morocco; Pakistan; Peru; Senegal; South Africa; Sri Lanka; Syria; Togo; Trinidad & Tobago; Tunisia	Algeria; Burundi; Cameroon; Central African Republic; Rep. Congo; DR Congo; Ecuador; Gambia; Ghana; Iran; Mauritania; Myanmar; Nigeria; Papua New Guinea; Sierra Leone; Venezuela; Zambia	Chad; Gabon; Guinea-Bissau; Malawi; Niger
Globalizers	Argentina; Bangladesh; Brazil; China; Colombia; Costa Rica; Cote d'Ivoire; Dominican Rep; Haiti; Hungary; India; Jamaica; Jordan; Malaysia; Mexico; Nepal; Nicaragua; Philippines; Thailand; Uruguay; Zimbabwe	Mali; Rwanda	Paraguay
Not included in Dollar and Kraay	Afghanistan; Albania; Barbados; Belize; Bhutan; Bulgaria; Cambodia; Comoros; Cyprus; Djibouti; Guyana; Hong Kong; Kiribati; South Korea; Kuwait; Laos; Lebanon; Maldives; Malta; Mongolia; Mozambique; New Caledonia; Panama; Poland; Romania; Seychelles; St. Kitts & Nevis; Tanzania; Vietnam	Angola; Bahamas; Bolivia; Ethiopia; Guinea; Liberia; Libya; Oman; Saudi Arabia; Solomon Islands; Somalia; Sudan; Suriname; Uganda; United Arab Emirates	Bahrain; Equatorial Guinea; Yemen
Total	72 Countries (of which 43 are included in Dollar and Kraay)	34 Countries (of which 19 are included in Dollar and Kraay)	9 Countries (of which 6 are included in Dollar and Kraay)

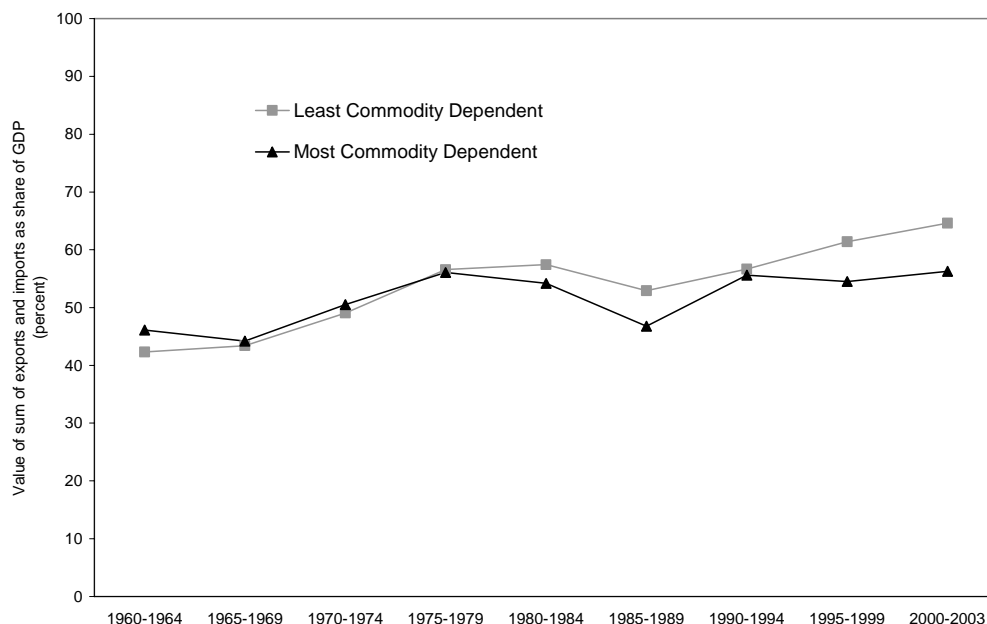
Source: Reproduction of table 2 from Birdsall and Hamoudi (2002).

Appendix Figure A1: Non-globalizers have participated in global trade as much as globalizers



Notes: There are 24 globalizers and 44 non-globalizers. Trade to GDP ratios are unweighted averages. See footnote 6.  
Source: World Development Indicators, 2005 and author's calculations.

Appendix Figure A2: Similarly, the most commodity dependent group of countries has participated in global trade as much as the least commodity dependent group



Note: There are 72 "least commodity dependent" countries and 34 "most commodity dependent" countries. Trade to GDP ratios are unweighted averages.  
Source: World Development Indicators, 2005 and author's calculations.