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I. Introduction

Today's rapid and profound international evolution requires an update of the development agenda. As East-West relations alter radically and forge history, new trends in global capital markets; telecommunications and new technologies erode inexorably the old structures and alter permanently the economic landscape. As the century turns, traditional issues of transfer of resources, debt rescheduling and the access to industrial markets must be re-examined. New items emerge on the development agenda:

1. The advent and explosive growth of the international securities market, a historically new trend in global capital markets, offers an opportunity to harness the enormous power of today's diffuse global capital movements towards the advancement of development goals;

2. Achieving leapfrogging technological change, and the simultaneous abandonment of traditional relative advantages, particularly in export markets;

3. Taking the initiative, capturing and controlling the environmental challenge in a way that serves the long term interests of the developing countries;

4. Implementing economic policies to take advantage of the new

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opportunities opened by the merger of Eastern and Western Europe.

This paper will address the first two of these development issues: capital markets and technologies, and it will examine them in connection with other more traditional issues:

—Voluntary transfers of resources;
—The debt crisis;
—The securing of markets for developing countries' exports.

II. Capital Requirements for Growth: Capturing and Diffusing Global Capital

Historically, foreign investment into developing countries has been large in relation to the size of the economy. It was often politically disruptive and socially indigestible. During the last ten years, a major change has taken place in global capital markets: small movements of capital started to occur through the advent and explosive growth of international securities trading, the trading of bonds and equity by citizens of one country into other countries. This growth of international securities trading is a new phenomenon which has major implications for industrial and developing countries alike, some of which will be explored in this paper.

Large investments originating in one country and realized in another have typically created conflicts between domestic and foreign interests. The inability of national governments to control the impact of such capital flows on their economies, often due to the disparity of their sizes, has led developing countries to choose foreign borrowing over foreign investment. The recurrence of debt crisis, and the current acute pains from short term debt servicing and the repayment of the outstanding debt, are the price paid for this choice.

It is useful to borrow an analogy from business practices. Borrowing vs. investment is a typical quandry in a growing firm which needs to raise capital to finance its expansion. The firm often faces the same issues faced by the countries in our previous paragraph: Investors are preferable because they share the fortune of the firm and therefore have the same incentives as the firm; but on the other side, investors also share the control of the firm's destiny. Large investors take over control. Borrowing, on the other hand, leaves control intact, but only up to the point where the repayment or servicing become problematic. At this point the situation reverses and all the control advantages gained from borrowing are lost. In the case of a country, national sovereignty

and independent domestic policies are often at risk.

The firm's typical solution is to seek many small investors. Control issues are then minimized, since the small investor is less able or desirous to exercise control. The small investors also share the fortune of the firm so that in bad times they are on its side and not against it as the lenders could be. Throughout the world, mature capital markets have evolved a complete and rapid system for raising investment of this sort. The crucial issue is the regulation of those markets: the better regulated the market is, the more efficient and successful. US capital markets, with their zealous attitudes towards the prevention of market manipulation (e.g. insider trading) are the best example of more regulation leading to better and more efficient markets. Despite commonly held views, regulation does not undermine the market efficiency. There is no contradiction between regulation and efficient markets if the regulation is right.

My recommendation for developing countries which face debt problems, is not to hope for or rely upon voluntary resource transfers from the industrial countries, although in certain extreme cases (e.g. Africa) this is in practice the only short term solution; nor to rely on further borrowing. It is clear that a day to day resolution to the debt issue has to be found and this involves negotiation, renegotiation and further renegotiation to decrease the principal and to cap interest rates. However, the aim of this paper is not to address these negotiations, but rather the longer term issue which will have to be faced during the next decade: how to prevent the repetition or worsening of debt crisis. The issue is how to deal with the need for capital without precipitating a crisis.

Firstly, one must set clearly the position that the need for capital is not a problem in itself, nor it is a problem to borrow capital from capital rich countries to finance expansion and growth. Basic economic theory establishes the principle that in an efficient world economy, developing countries will borrow capital from capital richer countries.

However, short term borrowing from private institutions, and in floating exchange rates, does not work. As an example, the Banco Central do Brasil *Boletim* reports that 89.1% of the 120 billion US dollar Brazilian debt is owed to private banks, with approximately 75% having less than 5 years maturity, and 94% a maturity less than 6-10 years. The fact that most developing countries' debt is short term, dollar denominated, and owed to private institutions can be said to account for most of the debt crisis today, see Chichilnisky and Heal (1987).

The recommendation is that developing countries should de-emphasize both further borrowing and the hope or reliance on aid or voluntary transfer of resources, in favour of diffuse private foreign investment into local firms through well regulated capital markets. However, for this policy to be successful, other policies must be implemented simultaneously:

It is essential to improve the regulation of domestic capital markets and to enforce such regulation, so as to prevent market manipulation, (e.g. insider trading, and the cornering of new issues by raiders). Both the US public and the Pakistani public are familiar with the issues. While it is generally known that the Karachi Stock Exchange has grown strongly in the last few years, aided by a developing new issue market, it is still small in scale and vulnerable to manipulation. The capitalization of the Karachi Stock Exchange is approximately US $ 2 billion. US financial markets are amongst the largest in the world, but they have also been vulnerable to such practices. In the Karachi Stock Exchange, however, there are few investors and the market does not always have the depth required for large new issues. In addition, according to the IMF estimates, about $ 1.7 billion is invested by Pakistanis overseas, and the Asian Development Bank (and Merrill Lynch) is to create a $ 50 m Pakistan Fund to attract some of this fund to be invested in companies listed in Pakistan. Similar funds have been created in Thailand, South Korea and the Philippines. Yet less than 1% of the Pakistani population of 120 million owns shares, a total of less than 700,000 investors (*Financial Times*, October 26, 1989). It is reported that in India large companies have several thousand investors while the number reported for Pakistan is about 250. These are the type of issues that should be carefully monitored and the expansion of this market must be encouraged by the appropriate regulation.

I have recommended taking advantage of a historical breakthrough in international capital market trends, the advent and rapid growth of international securities trading, to expand domestic capital markets and capture diffuse global capital flows into the economy. This would encourage private foreign capital investment into local companies, and domestic capital into domestic investment. Because of the characteristics of global securities trading, both of these can be made compatible with national control of capital and production. Such capital inflow can provide capital needed for the country's expansion without creating a conflict between domestic and foreign interests, and it could help decrease foreign borrowing. Foreign investors who own small

proportions of domestic companies will have the country's economic gains at heart, quite in contrast to the foreign investor who owns most of one sector of the economy, particularly an export oriented labor intensive sector. Such investors may have economic interests which are opposed to those of the national economy, and must be avoided.

For example, consider a large foreign company with a dominating presence in the banana exports from Central America. This firm may prefer a depressed local market with cheap labour rather than a strong domestic market with more skilled and therefore more expensive labor, because for such a firm local labor is only a source of inputs and not a component of its final demand. For such a firm, poverty is a relative advantage: such a firm chooses to invest in countries with poorly paid labor. Poverty, however, is never a relative advantage for the country itself. Even the most successful exporters in the world economy find that labor costs are not a determining factor of export success. West Germany, whose share of total world exports (about 12%) exceeds even those of Japan, has the one of the highest paid labor forces in the world.

The proposal is therefore to shift the emphasis away from two traditional development issues: the voluntary resource transfers to developing countries, and the management of the debt crisis. These two issues can be said to relate directly to the mismanagement of a very natural phenomenon: the excess demand for capital from growing nations.

In the last decade voluntary resource transfers (or aid) to developing countries have petered out to almost nothing, the US typically transferring less than 0.2% of its national product, in contrast with the United Nations agreed target of 0.7%. This depressing trend is likely to continue. Relying on the improvement of such voluntary transfers is therefore unrealistic. Economic theory has also shown in recent years that the long term impact of such transfers in a market economy, may harm the receiver by lowering its terms of trade, see e.g. Chichilnisky and Heal (1987). The continued practice of short term and floating rate indebtedness has also shown its weaknesses, and therefore should be avoided as much as possible.

Since it is clear that developing countries will continue to require additional capital for the foreseeable future, as predicted by economic theory, we propose that a possible solution is to advance the activity of domestic capital markets, and the appropriate regulation to assure their efficiency, in such a way as to capture the flow of capital currently

allocated to international securities trading throughout the world. International securities markets have grown tremendously, an average of 36.6% yearly since 1979 in value terms. The international equity market alone, when measured by secondary turnover, reached US $ 1,212.6 billion in 1988. This trend is likely to continue. This source of supply for funds is well known by those with experience in global capital markets. For other sources, see e.g. *International Equity Flows*, 1989 Edition, Howell and Cozzini (1989). While it is true that most of the international securities trading takes place between the industrial countries, a large and increasing part goes into the emerging markets of the developing world. Some US $ 7.5 bn is currently invested in country funds worldwide and this is expected to grow as emerging countries' share of the world economy increases. Emerging stock markets account for around 5 per cent of the world's capitalization and some 12 per cent of gross domestic product. There are currently 52 countries funds listed internationally, with the Korea fund by far the largest. This fund was launched in 1984 in New York by First Boston and Shearson Lehman in conjunction with the International Finance Corporation, and currently it has a market capitalization of US $ 725 million. Country funds started to blossom amid the trend towards globalization of the early 1980s. The stock market crash of 1987 dealt a severe blow to their development but this year investors have again turned to the emerging markets of the world. The issues are well summarized in a recent article by D. Hargreaves, *Wall Street Journal*, November 1989: "Emerging countries usually welcome investment from country funds since they help break a pattern of being overly dependent on debt finance and can channel funds from expatriates back into the country. Country funds often stimulate development, and for those institutions with strong stomachs, they can also offer huge returns".

III. Exports: Leapfrogging Beyond Traditional Relative Advantages

Another immediate reaction to the debt crisis is the emphasis on exports to raise foreign exchange. A successful increase in export revenues can obviously alleviate the debt predicament in the short run. However, in today's world economy the issue is how to secure export markets for the developing countries' products.

This is a very real issue in view of the level of protectionism displayed by many of the industrial economies, and their current trade wars. Developing countries facing such a world market worry legi-

timately about their chances of success. In this paper I shall not be concerned with the short term problem of how to secure the markets needed for developing countries to increase their exports. As in the case of aid, or resource transfers, I consider that this issue begs the longer term question of how to raise foreign exchange without harming the longer term prospects of the economy.

Even if successful in the short term, certain export-led policies may lead to economic stagnation and crisis in the longer run. The trap to avoid is the continued specialization on the volatile commodity markets, and on labor intensive exports. Many examples are offered in the references [Chichilnisky and Heal, (1987) and (1989)] about this phenomenon. It suffices here to mention that over the best years for oil market prices (1973-1982) middle income oil exporting nations grew *less* than middle income oil importers, see Chichilnisky and Heal (1989). The same reference shows that any list of the largest debtors in the world economy (by the size of debt service) includes five oil exporters among the top fifteen largest debtors. Not only did oil exports fail to promote faster growth; they also failed to improve the payments position of the exporting countries. Africa's ongoing plight is an indictment of the policy of specializing in resource exports. South and Central America present the same example for the specialization in labor intensive exports, along with raw materials. Neither has fared too well in their export plans.

The four Asian Tigers, Singapore, Korea, Taiwan and Hong Kong, on the other hand displayed what we call "leapfrogging" behaviour in export markets. They present the clearer example of what it takes to succeed in export oriented growth.

These four countries abandoned very quickly the labor intensive production in favour of capital and skill intensive exports. Examination of their export composition shows an extraordinarily fast shift away from traditional goods and labor intensive production particularly in the export sector. They had no illusions about pursuing their historically given relative advantages in labor intensive production.

This illusion comes from a misrepresentation of the classical Heckscher-Ohlin model of international trade, which simply and elegantly shows that trading is better than not trading, and that rather than not trading at all, countries are better of by selling each other what they can produce in better terms given their capital and labor endowments. This theory has been consistently checked for many years and the overwhelming conclusion is that it does not stand empirically, as

we teach in our textbooks, see e.g. Krugman and Obsfelt (1987). In addition, the theory certainly does not say that exporting more labor intensive products is better than exporting less of them: it only reflects on exports versus no exports at all.

Newer and more realistic theories of international trade, focused on North-South relations [Chichilnisky and Heal (1987)] have shown that exporting more labor intensive products can be strictly worse than exporting less. Specialization in such relative advantages could be a net loss for the country. The recommendation is to abandon traditional relative advantages on labor intensive and raw material markets, and leapfrog technologically to superior technologies and more rewarding market niches.

Relative advantages are not given: they are created. An important aspect of current technologies is that comparative advantage can be manufactured by appropriate economic environments and policies. In many technology-based industries competitive advantage depends upon skill and experience (via the learning effect) and on scale of production (because of economies of scale). In a country with a large domestic market, or with access to a large regional market, and with a skilled population, the scale and experience needed to compete on world markets can both be gained at home if the right policies are persued.

The expansions of local capital markets provides a natural demand for such new technologies. Telecommunications and computer links are the bare necessities in these markets. Communications are of the essence in trading; reporting and storing properly the information are equally important.

Leapfrogging toward advanced technologies may seem more difficult than slowly advancing through the industrialization ranks, but this is only at a first glance. Indeed, it is known that modernizing a traditional smoke-stack industrial economy is more difficult than adapting modern technologies from the outstart. The UK's often perceived reluctance to new technologies is generally attributed to its role in leading the industrial revolution and its pool of traditional technology embodied in its existing capital stock.

For this reason, we recommend the developing countries abandon traditional relative advantages in export markets and that their governments should sponsor leapfrogging technical change. This recommendation is particularly suited to countries, such as Pakistan, which exhibit a distinguished scientific tradition and a historical commitment to cultural achievement.

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