

GLOBALIZATION: STRATEGIC OPTIONS FOR DEVELOPING ECONOMIES

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I. Introduction

There can be no doubt that we find ourselves in the midst of a profound and qualitative change in the international economy. These changes are leading the world into a new political economy that is demanding “new instruments, new public policies and new rationales”¹ for States’ actions and their legitimization.

In this respect, the dramatic changes caused by the so called information technologies and the entire process of technological revolution that has taken place since the 1960’s is one of the main promoters of this new international political economy. They are also shaping a different world industrial organization and at the same time are producing changes in the role of the State in economic development.

If these considerations are immersed in a greater process or phenomenon called “globalization,” in general terms the role of the State can be supposed to be based upon the creation of guiding institutions that contribute toward reducing the uncertainties and complexities of globalization. Globalization is assumed to be a positive phenomenon because it increases the volume of exchanges and the income of participating economies. In this way, it contributes toward improving the quality of life for a great majority of the population in those geographic areas integrated with this process. However, this phenomenon is not free from inevitable accidents that become ever more serious and spread with incredible speed. Perhaps it is in the case of international financial crises when globalization acquires a relevant role in public opinion, to the point that many researchers and politicians might consider it a negative development. Economic disparity in the great majority of the capitalist societies is

¹ Hernán Gutiérrez B. and Claudio Rojas M., “La Institucionalidad Pública Chilena y su Contribución al Desarrollo Regional en el Marco de la Globalización”, *Estudios Regionales*, Universidad del Bío Bío, No.10, December 1998, p. 1

increasing. Stock market disorganization and economic contraction are creating unemployment, leaving people without the “cushion” of a social safety net.

If the role of the State is defined by the international political economy, the paradigm change that we face leads to the redefinition of its role with respect to the forms and objectives of its economic intervention and its relation with the private sector. That is to say, when it manages to generate an environment that permits the emergence of competitive advantages. (Porter: 1990)

The purpose of this research project is to assess the impact of the globalization of the world economy on States and their strategies for economic development. At the same time, it seeks to outline a series of strategic options available to developing economies for coping with the demands and new reality of global change. In this respect, we will try to focus mainly on the options available for two regions: Latin America and East Asia.

For the purpose of this research project, globalization shall be understood as the simultaneous effect of at least three major changes in the international arena: the accelerated internationalization of trade and production that led to transnationalization, the tremendous increase in capital mobility, and the greater mobility of knowledge or information flows, from basic communication to technology transfer. In this sense, it is possible to identify at least three important variables that affect the degree of integration of national economies with the global economy: technology, trade and capital mobility, and strategic alliances and network forms of organization.

Therefore, the appropriate management of these three variables will be what defines the role of the State in the development and economic growth of a nation and its integration with the global economy. Thus, the process of globalization and the changes in world politics mean that the Nation-State’s role and its institutions are changing dramatically, in both their domestic and external spheres and their forms of action. However, they also signify the need to reformulate public policies in

accordance with the demands of global changes related to the conditions for and factors of equitable development and sustained growth.

1. A Paradigm Change in the International Political Economy.

The milestones that marked the end of the Cold War during the period from the late 80s to the early 90s also put an end to the bipolar paradigm of international relations in all of its fields. Concretely, it meant the end of an ideological confrontation between two major powers that ruled and regulated the international order. A first phase, dating from the fall of the Soviet Union until the Gulf War, was marked by a triumphant optimism on the part of those who considered themselves the victors of the struggle. This gave rise to talk about a new international order characterized by the emergence of global democratic regimes, the establishment of bilateral and multilateral security and cooperation agreements and a global consensus on the benefits of the liberal economy². Special attention was paid to the conditions that would facilitate commerce between nations and, thus, global specialization. A second phase, starting from the conclusion of the Gulf War and including the present, is less optimistic. The disintegration of Yugoslavia and the ethnic wars in the Balkans, the wars in Rwanda and Somalia, conflict in Eurasia, the emergence of fundamentalism, the new forms of terrorism and organized crime (among other developments), led to growing concerns about the proclaimed international order, and instead we began to hear talk about international *disorder*.

This view was influenced by two conceptual approaches. First, Huntington's "clash of civilizations" where conflicts between civilizations will replace ideological and other forms of conflict as the dominant trend in international relations. Therefore the axis of world politics would rest upon the relationship between civilizations, particularly between the West and what he calls "the rest". Second, the neo-realists' "return to history" state that the future will be essentially like the past. Consequently, the new

² Russell, Roberto, "Cambios y Continuidades en las Relaciones Internacionales" in *Capítulos. América Latina y el Caribe en los Tiempos de la Globalización*, SELA, No. 47, Julio - September, 1996, p.18

world order will be marked by the classic rivalry between great powers (probably between Europe, the USA, China, Japan and Russia) that would compete, as in the past, for power and prestige. In the terms of international political economy, this approach corresponds to the “fragmentation” scenario. Under this scenario, opportunities for benefiting from the potential advantages of globalization, represented by more open and integrated markets, would be lost due to the rise of closed regionalism (fragmentation).

Additionally, between the optimistic and less optimistic periods, several intermediate positions have been proposed, but most of them tend to conclude that in one part of the world international relations will experience qualitative changes (developed countries) while in the rest of the world the past will repeat itself³. All of these approaches create a new problems for analyzing today’s world and its events. Therefore, the first step in our analysis will be the identification of the type of international order we are confronting, from among a continuum that runs the gamut from fragmentation and conflict to cooperation and harmonization.

The end of the bipolar Cold War paradigm meant: (1) a decrease in the importance of ideologies; (2) a change in the nature of basic competition, with political, military and ideological competition being replaced by economic competition and industrial and technological leadership; (3) the emergence of new global concerns such as environmental degradation, poverty, demographics, immigration, nuclear proliferation, drug trafficking, terrorism, corruption, nationalism and fundamentalism; and (4) the questioning of the role of international institutions and organizations.

Over the last few decades we have witnessed incredible growth in different regions of the world. Factors such as the expansion of commerce and capital flows, technological progress and the different types and degrees of association have played a key role in this fast paced development. However, all of these factors are determining characteristics of one overarching process: globalization.

³ Russell, Roberto, IDEM, p.20

Globalization offers multiple and different definitions. Basically, it refers to a world in which societies, cultures, politics and economies have, in some sense, come closer. On a basic level this is understood as the process of growing interaction and interdependence that takes place between the various units that constitute the global system⁴. Processes are multidimensional, encompassing various activities and their effects on countries, regions, multinational enterprises, international organizations, public and private organizations and social groups and movements. The concept is commonly used with an emphasis on the economic approach, that is, what is referred to as the “globalization of the economy”. In this sense, attention is placed on some actors (companies, transnational financial agencies) and processes (technological innovation, transformation of the productive system, and the creation of worldwide networks in different fields) at the expenses of others.

On the threshold of the 21st century, globalization has crudely expressed itself through a global financial crisis that has also had a significant social and political impact on different regions around the world. It is clear that finance is becoming the force that moves the real economy and not viceversa. This is demonstrated by the fact that the volume of financial transactions during the last few decades have been approximately twelve times greater than the total volume of commerce.

On the one hand, globalization brought into focus the vulnerabilities of nation states to cope with the new forms of global capitalist developments⁵. On the other hand, there is enough evidence to speak of a crisis in the so called *Washington Consensus*, which has pursued the objective of complete liberalization, without regulatory frameworks and concerns about the social effects and political consequences of a particular form of capitalist development.

⁴ Carlos J. Moneta, “Los Procesos de Globalización, Reflexiones sobre su Concepción y Efectos sobre la Evolución del Sistema Mundial, *Estudios Internacionales*, No. 106, 1994, p.175

⁵ Francisco Rojas A., “Globalización y Orden Internacional” in Francisco Rojas A. (ed.), *Globalización, América Latina y la Diplomacia de Cumbres*, FLACSO-Chile, Mc Graw Hills, Santiago, 1998, p.14

At the same time, the structure of the current international system is being called into question within the spheres of action of financial organizations and the world's principal decision making forums and different types of financial, trade, political and social architectures have been proposed. In short, we are hearing calls for the readjustment of the current architecture in order to respond to the impact of globalization.

A series of options have emerged from the debate on this issue. These options range from greater liberalization policies to the establishment of supranational regulatory frameworks, or even "deglobalization". Of course this is a very wide spectrum of options that would imply a more in depth and prolonged discussion within the domestic and external domains of any nation. However, what is clear by now is that the root cause of dissatisfaction and lack of a timely response is the inadequacy of present mechanisms for international economic consultation and cooperation at responding to the problems facing the world today.

In this sense, a new international consensus is appearing that moves toward greater regulation. Therefore, the development of a wider range of governmental capabilities is a top priority for allowing the establishment of regulatory frameworks, especially in the financial sector. It has also been suggested that the time has come to re-think the role of the State itself, to reinforce its capacities for designing, formulating and applying norms and rules that allow a country to confront the challenges of globalization.

The crisis of the State is made evident when we consider one of its defining characteristics: its sovereignty. The State's loss of control over the regulation of key aspects of the international economy is producing a change in the political economic configurations of power. The territoriality of the global economy is finding expressions in the emergence of megacities that become more important as poles of decision making, especially for the financial and trade sectors. According to Kenichi Ohmae we are witnessing the birth of regional states that do not necessarily compete against central governments. However, this new strategy demands the implementation of

policies and tools that allow for a flexible relationship between regional States and national States.

In short, the intensity of global transactions, the increase in international trade and the simultaneous tendencies toward integration and fragmentation demand greater degrees of certainty. To meet this demand, greater stability is required, which is achieved through the development of governance capabilities. This can be accomplished to the extent that the State is capable of acting appropriately on the domestic level and in international concert for adopting supranational measures.

1.1 Stating the Causes, Consequences and Variables of the New Paradigm

1.1.1 The Impact of Technology:

As a market phenomenon, globalization acquires its basic impulse from technological progress and particularly in the capacity of this progress for reducing the costs associated with transporting and moving goods, services, capital, information and individuals. Dramatic increases in the scale of technology in many industries (in its cost, risk and complexity) have rendered even the largest national markets too small to be meaningful economic units⁶. National markets are no longer the main entities of the world economy. National markets are *fused* transnationally rather than linked across borders.

For developing countries an issue of considerable concern is the possibility that they could find themselves “delinked” from global tendencies for technological development, which is related to the marginal role that they play in the generation of technological knowledge. In point of fact, strategic alliances formed to exploit and develop technology are largely limited to the participation of large companies based in the OECD countries. Therefore developing countries should assign greater importance to the *application* of technologies available internationally. Other vehicles, such as

⁶ Stephen J. Kobrin, “The Architecture of Globalization: State Sovereignty in a Networked Global Economy” in John H. Dunning, *Governments, Globalization, and International Business*, Oxford University Press, London 1997, p.149

international trade in capital goods and foreign direct investment, are better suited for effecting technology transfers to developing countries than strategic alliances.

An international world economy has to be built through the cross-border integration of national economic spaces. In this case, the expansion chain goes from the local to the national to the regional and ultimately to the international level. The historic explanation for this process is that the supply of certain goods has been located in one geographic area and the demand in another. This tendency is also explained by the fact that geographic expansion permits a more productive division of labor with profits obtained from specialization and the exploitation of differences in resource endowments. Additionally, spreading fixed capital costs over a larger market area can reduce unit costs and produce gains from economies of scale.

Finally, the growth of international investments has prompted governments to deregulate capital movements, which in turn has facilitated investment and technological change⁷.

1.1.2 Trade and Capital mobility

Trade and capital mobility is another variable that affects the degree of integration of national economies with the international economy. Thus, it serves as another engine of globalization. This leads us directly to what has been defined as market globalization, which means the increase in the flows of capital, goods and services across national borders. Market globalization can be measured in terms of the volume of trade and capital flows, which indicate differences in the breadth and extent of the integration of countries and regions around the world⁸. Market globalization -- its evolution, sources and its implications -- can be seen both in the areas of *commerce* and *capital flows*.

⁷ Robert O. Keohane and Helen V. Milner, "Internationalization and Domestic Politics: An Introduction", in Robert O. Keohane and Helen V. Milner (eds.) *Internationalization and Domestic Politics*, Cambridge University Press, Cambridge 1996, p.12

⁸ John Ikenberry, "Globalización, regionalismo y el Futuro de la Economía Mundial, p.85

Since the end of World War II, trade has expanded consistently and steadily between industrialized economies, at a pace three to four times faster than the growth of domestic product. As a consequence, these economies have become more and more dependent on trade, which has prompted them to become more integrated under one international trade order. To date no serious evidence has surfaced which would suggest a reversal of this situation. World trade is valued at approximately \$10.6 trillion per year, an increase of 2.5 times versus the total amount recorded for 1986⁹. However, it should be noted that, at least over the last two decades, developing economies have been increasing their participation in and benefits from international trade. A great deal of the expansion of trade in the last decade has taken place between the newly industrialized countries of Asia and Latin America and the advanced economies.

This increasing dependence on trade growth influences the economic policy of all nations. Governments are forced to create or provide the right environment for enhancing the competitiveness of national producers in international markets. Nations that have engaged in open market policies must compete successfully in international markets or else their prospects and potential are dim. Unemployment will rise and economic growth will slow down¹⁰. In other words, the implication of greater trade integration for governments is that the costs of closing their economies increases, which in turn restricts the range of options available to governments for managing internal economic dislocations. When the economic activity of a country depends more and more on foreign trade, the dependency of such a country upon the actions of others increases. This also means that with market globalization States must concern themselves more with the stability of international relations and maintaining economic openness.

⁹ John Ikenberry, *Idem.*, p.85

¹⁰ Geoffrey Garret, "Capital Mobility, Trade and Domestic Markets" in Robert O. Keohane and Helen V. Milner (eds.) *Internationalization and Domestic Politics*, Cambridge University Press, New York 1996. p.89

Capital mobility can also be considered a type of market globalization. The increasingly free nature of capital summarizes the logic of globalization. More than \$1.2 trillion dollars change hands every day, reflecting an increase in trade and investment across borders, but owing fundamentally to speculative monetary transactions and arbitration. It is precisely the globalization of financial markets which is limiting the economic autonomy of the modern State and transforming the Nation-State system. The logic of capital becomes less and less concerned with national borders, seeking instead the most profitable opportunities.

Globalized capital markets create limitations for many States in the macroeconomic management of their economies. The process by which capital mobility influences economic policy can be stated in the following terms: the easier it is for asset holders to move their capital offshore, the stronger the incentives for governments to pursue policies that will increase rates of return on domestic investments¹¹. Given that it is more difficult for entrepreneurs with fixed capital investments in plants and equipment to redeploy their assets than it is for those investing in stocks, bonds or currencies, the expected reaction of financial markets is likely to be the primary constraint on government policy in a world of mobile capital

As a result of its mobility, capital can rapidly abandon a State when expectations hold that its exchange rate is set to depreciate. Foreign exchange markets are volatile and tend to react dramatically to small changes in fundamentals (interest rates, budgetary balances and inflation). States run the risk that their economic decisions could lead to an unsustainable increase or decrease in the value of their currencies. Additionally, if a government wishes to seek a loan in the international capital market it must follow policies that maintain investor confidence. This creates a structural incentive for the governments to implement conservative macroeconomic policies, placing an enormous priority on low inflation and a lesser importance on growth and employment.

¹¹ Geoffrey Garret, *Idem.*, p. 88

Finally, the rapid growth in foreign direct investment has also been one of the most important sources of change for the global economy. Over the last few decades, we have witnessed an important increase in FDI flows. In general, FDI flows have grown at an annual rate of 11%. This increase has not only been in terms of the amount of the flow but also its geographic expansion and diversification. During the 1980s FDI was mainly concentrated among industrialized areas such as Japan, North America and Western Europe, while in the 1990s developing regions in Asia and Latin America played host to larger flows of FDI and also a greater number of investors.

1.1.3 The Emergence of Strategic Alliances and New Forms of Organizations

In many cases, strategic alliances are an indicator that the scale of technology (its cost, risk and the complexity of R&D) has expanded to such a point that it has exceeded the reach of even the largest and most globalized firms. Alliances also provide evidence for the assertion that a global network of cooperation is replacing trade and investment by a single company, which represents a shift in the mode of organization of international economic transactions.

The motivations behind the construction of strategic alliances are multiple and complex. However, the following factors can be highlighted: (1) market access creates the need for competing in all of the most important markets; (2) the importance that the economic activity of companies within national boundaries still holds for local governments, where promotion policies oriented toward local industrial sectors favors the establishment of alliances with national or regional leaders; (3) an interest in making competition less onerous as a motive of collaboration; and, (4) the most important motivation, the increasing cost risk and complexity of technology. In addition, globalization has prompted the expansion and evolution of corporate production. The rise and diffusion of foreign direct investment has been one of the most important drivers of change in the global economy. That is, the globalization of production has prompted the expansion of transnational corporate activities. Today's international business is organized on a more complex and extensive productive and

operational basis, and by means of FDI international corporations buy and create subsidiaries around the globe. As a consequence, this expansion of corporate production and business is creating for national economies a different mode of integration with the international economy that goes beyond the traditional pattern of economic interdependence and the cross border exchange of goods and services.

With greater frequency large multinational corporations are associating with their competitors to form specific joint ventures in order to share the burden of costs and risk as well as guarantee market access. Therefore, the more internationalized these corporate activities become, the greater corporate interest in maintaining an open and stable global economy, whether it be between states, regions and/or blocks. In short, this growing tendency is causing national economic identity to become less precise, undermining governmental capacities for clear decision making that would favor economic nationalism.

Finally, the recent explosion of transnational strategic alliances is a manifestation of a fundamental change in the mode of organization of international economic transactions from markets and/or hierarchies (trade and MNCs) to postmodern global networks. That is, network forms of organization represent a new distinctive mode of coordinating economic activity and economic organization. A 1992 OECD report, defined “network” as a distinctive form of organization, representing a type of arrangement with its own specific, distinctive features which henceforth must be considered in its own right¹².

In this sense, the emergence of international strategic alliances signal the replacement of integrated transnational hierarchies by global networks, that is, a cooperative and reciprocal organization of economic transactions. However, even though trade and capital flows are relevant to the formation of strategic alliances, the most important flows across transnational networks are intangibles: knowledge and information. To

¹² OECD, Organization for Economic Cooperation and Development, *Technology and the Economy: The Key Relationship*, Paris, 1992, p.78

summarize, transnational networks are the result of the information age, postmodern organization held together by information technology.

2. The Declining Role of Nation-States under the New Paradigm

2.1. Challenges to the Nation State System

One of the greatest impacts of globalization is reflected in the weakening of the structure of the Westfalian order. Although globalization does not bear exclusive responsibility for this¹³, it has certainly contributed to the erosion of the Nation-State. In this sense, the crisis of the Nation-State can be witnessed in three spheres. First with respect to its defining principle, the sovereignty of the State. However, in order to understand this dimension of the crisis we must define sovereignty. For Robert Keohane (1993), formal sovereignty is a legal concept implying supremacy within a territory and independence of outside authorities in the exercise of state authority¹⁴. In other words, the State's supreme power over its people and territory. The second sphere refers to the crisis of the State's basic pattern of behavior, that is , the surge for autonomy in a world characterized by interstate rivalries and competition. Thus, autonomy implies that a State can and does make its own decisions with regard to internal and external issues. And third, the crisis of the rules and norms for coexistence and of the institutions that acted as foundation for this order, especially in relation to the balance of power (military, political and economic); the competition between international powers and their areas of influence; and war.

Numerous and well known arguments have demonstrated the impact of globalization upon Nation States. What is definitely clear by now is that the dynamics and organization of the contemporary global economy and the technological revolution have made borders obsolete, altering the nature of time and space in global politics.

¹³ This crisis of the Westfalian order extends beyond economic globalization. It also involves changes in political regimes, profound cultural shifts and the revolution of "people's abilities" and their parametric conceptions, quoting J. Roseneau, *Turbulence in World Politics*, 1990.

¹⁴ see Robert Keohane, *Preparing for the Twenty First Century*, Random House, New York, 1993

Within this framework, the state is less autonomous and has less control over the political, economic and social processes that take place within its territory¹⁵. This is the main reason why many researchers are calling for the end of the era of the Nation State and warning that governance at the national level is less effective when facing economic globalization. Kenichi Ohmae describes States as “local Authorities” of the global system. Under this conception, states are just in charge of providing basic services. However, under this new framework it is an imperative to redefine the role of the State and reassess the concepts of sovereignty and autonomy in the post Westfalian order.

It is clear, then, that globalization, in particular its impact upon the integration of markets and productive processes, has undermined the Nation-State as the privileged sphere for regulation, favoring instead those factors that affect its capacity for both innovation and its diffusion and its ability to provide the impetus for business and collective projects.

One of the most important changes currently affecting the relationship between the actions of the State and its environment is the question of who exercises influence over whom. Until two or three decades ago, the State was the entity with the principal responsibility for guiding growth and development. Today, globalization has modified this role, granting greater influence to the international economic environment instead. In this sense, Nation States are progressively losing autonomy in the determination and praxis of their economic policy and also their capacity for safeguarding the values of society and its political, economic and sociocultural institutions.

In the international arena, the process of globalization demands the modification of the previously suitable paradigm of international relations, which granted the Nation-States the role of principal and predominate actors within the system. The Nation-State is becoming just one part of a bigger system: the Global System¹⁶.

¹⁵ Roberto Russell, “Cambios y Continuidades en las Relaciones Internacionales, in SELA, *Capitulos. América Latina y el Caribe en los Tiempos de la Globalización*, No. 47, July-September 1996, p.28

¹⁶ Carlos Moneta, op. cit., p. 175-176

In this sense, the interactions correspond to two types of actors and their respective systems. The first is the “State-Centric” system with Nation-States as the main actors and their interactions and international organizations. The second is the “Multi-Centric World” system formed by non-governmental transnational and sub-national actors that have objectives, autonomy and their own means of action (Rousenau: 1995)

The global system plays host to a permanent game of interactions of both a conflictive and a cooperative character between the State, national societies, international entities, transnational companies and other transnational actors. This is not a new phenomenon but it has been deeply modified by (1) the distribution of power in the system; (2) the rules of its operation; (3) the character, frequency, complexity and dimension of the interaction; and (4) the relative capacity to orient processes.

2.2 The Question of Development

The growing interdependence of national economies around the world is the result of greater levels of trade and capital flows and rising inter-firm technological cooperation. This tendency reflects the liberalization of trade, especially in the 1980's, as well as the worldwide deregulation of financial markets and other business services like banking and insurance. All this has led to more competition in the world economy, new profit opportunities for international investors and has greatly contributed to the modernization of exporting sectors.

Trade in goods and services, as well as capital flows in terms of FDI and other sources of financing and investment are growing rapidly. This tendency has provided a great opportunity for the more advanced developing economies, allowing them to implement export oriented strategies based on very dynamic exporting sectors.

However, all of the impressive advances stemming from globalization do not necessarily mean the end of the Nation State or the end of geographic borders. Even if we have discussed here the depth, the degree of influence, the extension and the intensity of globalization, it is important to note that it is a partial, heterogeneous, unbalanced and possibly insufficient process. International trade and FDI are still notably less important than domestic trade and national investment around the world. For example, FDI in the world is between 5% to 10% of total annual investment and international trade is between 15% to 20% of world production¹⁷.

Therefore, developing economies still need to promote all of the above mentioned exchanges but they also need to be aware of the costs involved in this process. The role of national public policies is very important as are efforts for national, regional and international integration.

At the same time, the character and specific nature of the public policies applied continue to be relevant since there is no one “recipe” for meeting the objectives imposed by economic, social and cultural globalization.

Economic globalization has surpassed political and socio-cultural globalization in terms of its degree and intensity, yet even so the decisions on production, employment, inflation, and, in general, all those issues which affect the daily life of a nation, remain in the hands of the Nation State. As a result, it would be a serious error to condition public policies on the consequences that may arise from a single dimension of globalization. Although it cannot be denied that often the harmonization or removal of regulations comes as a response to market pressures, the opposite can also occur, that is to say that occasionally public policy decision can promote and accelerate market integration and, consequently, the movement towards globalization.

¹⁷ Ricardo Ffrench-Davis, “Políticas Públicas y Globalización Económica” in Francisco Rojas (ed), *Globalización, América Latina y la Diplomacia de las Cumbres*, FLACSO-Chile, McGraw Hills, Santiago, 1998, pp. 151-152.

Both situations may take place separately or in combination. However in order to avoid provoking a strong or unexpected impact on national economies, especially in the developing countries, it is important to know what globalization is understood as, and therefore formulate *the optimal policies* that allow a country to best take advantage of the phenomenon.

If we define globalization as a closer international integration of production and markets, then we can say that globalization improves the prospects for developing countries to catch up economically with industrialized countries. Depending on economic policies and strategies towards openness and factor accumulation, globalization may increase capital and technology flows to developing economies, thus generating a higher rate of income growth than would be possible in a less integrated world economy.

Therefore, developing economies have to adjust to the changing international environment if they want to participate in the current globalization process of production and markets.

3. The Strategic Options for Developing Economies

There can be doubt that globalization and its above-mentioned components have affected economic activity, the wealth and stability of the current economic system, and the range of options open to governments, firms and individuals. Now the question to be addressed is whether any of these are likely to be freer, better off or safer within a globalized world. There is no clear or precise answer to this question, but perhaps there is still space for the exercise of State action and its governing duties for implementing policies that allow it to assure domestic well being and position itself properly in the external arena.

These possible macro policies or “grand policies” are the so called *Strategic Options*, defined by Peter Smith (1998) as “opportunities for relatively long term, consistent

policies to protect and promote the interests of Nation-States”. In the following pages and in light of the arguments presented in this paper, we will try to outline a series of these grand policies available for two developing regions, namely: East Asia and Latin America. But in order to understand the international context in which these policies must interact, some attention should be devoted to the current Asia Crisis.

The Asian Crisis has generated an increasing lack of confidence in emerging economies. Therefore, perspectives toward them will be mainly determined by the perceptions of investors and international analysts. This meant that today all developing economies are facing two challenges. First they need to cope with the demands of globalization if they want to be part of the club of globalized economies. Second they need to regain the confidence of international investors and the stability of their markets.

The crisis in Asia started mainly in the financial sector but rapidly transformed into a serious crisis for the real economy, affecting all the countries in the region. The hardest hit countries (Thailand, South Korea, Indonesia, the Philippines and Malaysia) experienced highly negative social and environmental impacts, as well as problematic effects for political stability.

To understand the unexpected crisis in Asia and its spread it is important to examine its causes. There are three key elements to the crisis that started in 1997. First, the roots of external imbalances were grounded in private sector deficits, as most East Asian governments were running budget surplus. Second, it is possible to consider the crisis in Asia as a consequence of over-investment and not over-production. In this respect arguments can be made about the quality of the investments undertaken, since capital was clearly misallocated, especially in the property and electronic sectors. Third, an important cause of the crisis was a sharp deterioration in confidence throughout the region, spread through contagion effects, rather than significant changes in macro-

economic fundamentals¹⁸. However these three elements were and are present in many other economies without really causing a crisis on the scale of the 97-98 shock. Most of these countries were highly successful economies with long track records of good economic management, dynamic export sectors, low rates of inflation and high saving rates. What really deepened the crisis in Asia was probably the sum of the three above-mentioned variables, plus the existence of important weakness in the internal financial system of each one of these economies. Particularly important was the situation of the banking sector which proved to be improperly regulated, with weak and practically non-existent monitoring and regulation of private short term debt. Part of the blame also can be attributed to the way in which capital account liberalization had been handled in economies that had strongly regulated and administered this area previously. Liberalization greatly promoted the entrance of short term capital flows and this, when coupled with the existence of fixed exchange rates policies and currencies pegged to the US dollar, resulted in their overvaluation.

However, we cannot just blame the emerging economies of Asia. International capital markets have proved to be imperfect, especially with respect to the behavior of international capital flows. Financial panic has characterized all historic financial crises, but today its impact is magnified due to the speed at which markets can react in today's global economy¹⁹.

The logic of the Asian Crisis, the Latin American crisis of the early 1980's, the 1994 Mexican peso crisis and the recent crises in Russia and Brazil can be explained almost by the same pattern. When successful economies emerge from among the ranks of developing countries they tend to offer high returns by means of yields as well as capital gains. If the entrance of foreign capital is facilitated by these countries through the liberalization of the capital account, foreign investors will quickly seek to enter

¹⁸ Stephany Griffith-Jones, *A New Financial Architecture for Reducing Risks and the Severity of Crises*, paper presented at the International Seminar: *The Globalization of Financial Markets and its Effects on the Emerging Economies*, organized by the International Jacques Maritain Institute and the Economic Commission for Latin America and the Caribbean (ECLAC), Santiago, Chile 29-31 March 1999, p.3

¹⁹ Stephany Griffith-Jones, *Idem.*, p.4

these markets generating an increase in capital inflows which have an affect upon other key economic variables. Exchange rates become overvalued, the price of assets (real estate and stocks) rises quickly and real income increases as does perceived wealth. At the same time, banks tend to relax lending standards and firms increase their debt to expand their business. As consumption and investment also rise, the country's balance of payments deteriorates. This situation does not necessarily signify trouble, but if foreign investors and lenders change their sentiments towards these economies, then they will face serious problems.

A slight change can sometimes trigger a sharp modification in the perceptions held by international investors and lenders, creating a serious, large scale and rapid lack of confidence that can reverse capital flows dramatically. The damage that can be done by sharp changes in capital flows is far greater when a high proportion of the inflows are short term and easily reversible, as was the case of the East Asia economies²⁰.

The blow to the East Asian countries was devastating: in 1996 the region enjoyed a capital inflow of \$93 billion, but experienced an estimated \$12 billion outflow in 1997, a \$105 billion shift from one year to the next. The largest component of this reversal of fortune is explained by commercial bank loans, followed by short term portfolio flows, while FDI flows remained constant. The dramatic drop in capital flows to the principal economies of East Asia represented more than 10% of their combined GDP, a sharper plunge than that experienced by Latin American economies during the early 1980's (8%).

The hardest hit countries in Asia, Indonesia and Thailand, experienced extremely negative economic and social effects. Indonesia's GDP shrunk by approximately 15% in 1998 and Thailand's by around 8%. Even though other economies suffered significant declines in GDP growth and witnessed a sharp fall in employment and real incomes, the cases of Indonesia and Thailand are particularly worrisome. Many successful advances which had been made in reducing poverty in these economies were

²⁰ Stephany Griffith-Jones, *Idem.*, p.5

wiped out, with the number of people living below the poverty line in Indonesia leaping from about 20 million to 80 million²¹. The reality is that the poor are always hit the worst by this sort of crises.

For Latin America the Asian crisis has had a direct impact on the region's trade as a result of the decreased Asian demand. Additionally, indirect impacts have been associated with the deceleration of global economic growth, which has triggered the following developments: (1) the drop in the prices of primary products; (2) the competitiveness of the Latin American economies has suffered as a result of the weakening of the currencies struck hardest by the crisis; and (3) the climate of distrust in emerging markets threatens to prolong the "flight to quality" phenomenon and keep external sources of financing prohibitively expensive.²²

Today, Asia and Latin America need to recover from these shocks and both regions must pursue the same general objectives, which are: (1) seeking macroeconomic stability and reducing vulnerability; (2) improving productivity and increasing international competitiveness; and (3) protecting the poor, that is, how to avoid social disintegration. Success in achieving these objectives will depend upon the policies implemented both within the internal arena and with respect to the region's ties to the external environment. We therefore must turn our attention to identifying the necessary prerequisites for implementing successful policies with the framework of globalization.

International analysts and investors evaluate emerging economies through a series of criteria, such as: (1) level of development; (2) growth potential; (3) the degree of internal and external macroeconomic equilibrium; (4) political risk and the credibility of economic policy; and (5) the state of the banking system. Considering these criteria we can posit that emerging markets around the globe should meet the following prerequisites if they wish to successfully join the club of globalized economies. First we

²¹ Stephany Griffith-Jones, *Idem.*, p.6

²² SELA, *La Crisis Asiática: Riesgos y Oportunidades para América Latina*, Paper presented at the Seminar: "La Globalización de los Mercados Financieros y sus Efectos en los Países Emergentes," organized by Instituto Internacional Jacques Maritain and ECLAC, Santiago - Chile 29, 30 and 31 of March, 1999.

must identify the variables directly associated with domestic macroeconomic performance: it is important to maintain steady and sustained growth rates of at least 5% to 6% annually; to control inflation, posting a one digit annual rate; and public finances must be kept under control, avoiding a public sector deficit. The qualitative variables that account for the public perception of political risk, the credibility of economic policy and the state of the banking system are also important. Developing economies that enjoy a good reputation in international markets are those supported by their strong macroeconomic fundamentals, political stability and clean banking systems, such as the cases of Taiwan, Hong Kong, Chile and Malaysia. . The first three countries mentioned are considered to have superior international financial credibility: Taiwan is the country least effected by the crisis in Asia; Hong Kong successfully managed the speculative attacks against its currency in October 1997; and Chile is the only Latin American country that has avoided major instability, mainly due to its regulations on short term capital flows. In the case of Malaysia, its credibility will depend largely on how the controls imposed last year by Dr. Mahathir on foreign capital flows are lifted by September 1999.

Secondly, the evolution of the exchange rate in the medium term is an important factor for determining the stability of developing economies. In this sense the degree of external financial vulnerability is also relevant, expressed by the importance of an economy's current account deficit and the strength of its external position (that is, the relationship between international reserves and short term foreign debt). Argentina, Mexico, Uruguay, China and India are relatively solid economies, but they are vulnerable because of the high degree of foreign debt and their potential for experiencing foreign trade imbalances.²³

²³ SELA, Secretaria Permanente del Sistema Económico Latinoamericano, *La Crisis Asiática: Riesgos y Oportunidades para América Latina*, paper presented at the International Seminar: The Globalization of Financial Markets and its Effects on the Emerging Economies, organized by International Jacques Maritain Institute and the Economic Commission for Latin America and the Caribbean (ECLAC), Santiago, Chile 29-30 March 1999 pp. 4-5

Taking into account these prerequisites and their own relative position in the international context, Latin American and East Asia economies might consider the following strategic options:

- **Openness and the Closed Alternative:** Commercial and financial globalization have a disciplinary impact on governments. Economic openness brings with it the promise of greater economic growth and an increase in living standards, but also restricts government policy choices. This makes it difficult for governments to apply Keynesian policies and utilize stabilization instruments within the national economy. It also has created new incentives for making use of microeconomic measures to help in the management of the economy, such as deregulation and research and development. But the opening of the national economy is the result of conscious State policies -- policies that can be changed, although the cost of doing so may be high or increasing.

In the case of trade, countries that opt toward openness must take into account the interconnection between technological innovation, financial markets and productive activity. Exports really matter to the extent that they contribute toward productive development, stimulating higher levels of investment and production and the full utilization of productive capacity, in this way generating productive employment. In this sense, developing economies need to create spaces for improving their position in world trade. To do so they need to invest in human resources, education and training and public infrastructure; develop immature markets; create a stable macroeconomic environment; and establish and strengthen long term capital markets, improving access to capital for new small and medium-sized companies.

As the emerging economies liberalized their capital markets during the course of the last decade, they experienced an enormous inflow of funds and their internal economies grew rapidly as their companies expanded production. But when indications of over-production and loan defaults appeared, foreign capital abandoned these economies with the same speed. The government of Malaysia,

probably more than any other, is reevaluating its commitment to openness toward foreign capital, as is Brazil in the wake of the strong impact it felt from contagion effects.

Those countries which have a strong dependence upon foreign capital and foreign investment for maintaining growth and employment must constantly respond to the demands of foreign markets. To a great extent, the nature of national financial, social and governmental institutions determines the degree of success attained by this process.

A consequence of the above-mentioned is that labor finds itself at an increasingly greater disadvantage in relation to capital. The globalization of financial markets has granted capital holders a wider range of available options, but labor continues to be much less mobile. The result has been a decrease in the political power of labor among advanced industrialized societies and lower labor influence in the industrialized economy.

- **Financial Liberalization and the Regulatory Framework.** While increases in the international trade of goods and services have far outstripped the growth of domestic production, the movement of capital around the globe has grown even faster than that of trade²⁴. From 1980 to 1990, the volume of cross border equity transactions grew from \$120 billion a year to \$1.4 trillion.²⁵ It is precisely the “hyper mobility” of capital which is argued to have undermined the ability of Nation States to guide economic activity within their territory. Facilitated by the development of new communication technologies, capital flows dart rapidly around the globe, undermining the ability of the Nation State to control its national currency and other important economic variables. This is undoubtedly the most globalized form of economic activity.

²⁴ Keohane and Milner, op. cit., p.13

²⁵ Ray Kiely, *Globalisation, (post-) Modernity and the Third World*, Routledge, London 1998, Introduction, p.11

After decades of applying controls on capital movements, the international activities of domestic financial institutions, and the entry of foreign financial institutions into their countries, in just the last few years developing economies have opened their financial systems by liberalizing capital flows and the rules governing the international operations of financial intermediaries.

For capital account liberalization policies to produce optimal results, developing economies have to meet a number of prerequisites. If this policy is premature and poorly conceived costs will be very high, since capital account liberalization erodes domestic financial controls, eliminates a tool of both industrial policy and patronage, and reduces the opportunity for governments to finance themselves through the sale of bonds at lower than world interest rates.²⁶

Therefore, a knowledge of how to confront large-scale foreign capital inflows is crucial. Of course, this also depends on the nature of the capital flows. If capital enters an economy as FDI and generates new productive capabilities and facilities, it can have a more positive impact on the economy. If, however, capital flows enter an economy in the form of dollar-denominated bank deposits or through the purchase of existing shares in the stockmarket, creating pressures for a monetary revaluation (that is, the strengthening of the domestic currency) and disincentives toward internal investment while stimulating consumption, they can be highly risky.

Short term capital markets around the globe are becoming much more interconnected than productive markets. As a result, today economies are facing enormous amounts of capital flows that can enter and abandon a country at will, creating problems both for developing as well as developed economies, especially if they do not adopt efficient measures for protecting themselves in a constructive fashion. In this case, increasing monetary policy autonomy by applying mechanisms that impede the excessive entrance of capital, especially short-term capital, can be

²⁶ Stephen Haggard and Sylvia Maxfield, "The Political Economy of Financial Internationalization in Developing World" in Keohane and Milner (eds.), *Idem.*, p.210

an optimal policy: as examples we can cite the 30% reserve requirement tax applied by Chile and Colombia or the taxes imposed in Brazilian.

It is now clear that due to their volatility and reversibility some categories of capital flows can have very negative effects upon developing economies. As a consequence, a consensus has emerged that the current international monetary system, as well as the policies of recipient countries, need to undergo important changes in order to avoid costly crises and/or to avoid mismanagement once these crises arise. However, any measures taken with this aim in mind should contribute toward broadening and not limiting the access of developing economies to capital flows, especially long term ones. In this sense, it is important that any new measures do not discourage FDI flows toward developing economies, since they contribute not only more stable source of capital flows, but also provide technological and managerial know-how and better access to markets.²⁷

Any change leading toward a new financial architecture should be based on the concept of non-discriminatory membership (where developing economies can actively participate in decision making), should enhance transparency and the disclosure of information, strengthen financial systems in both national and global economies, and include appropriate burden-sharing mechanisms for handling international financial crises.

- **The Social Safety Net and Keynesian Policies.** It is possible that globalization may lead toward social disintegration and generate a violent reaction against the expansion of international trade. The processes associated with the global integration of markets for goods, services and capital are creating three sources of tension. First, lower barriers to trade and investment increase asymmetries between groups that can cross international borders and those that cannot. Among those that can cross borders are the owners of capital, highly trained workers and many professionals. Non-trained or poorly trained workers and the majority of mid- level

²⁷ Stephany Griffith-Jones, Op. cit., p.9

executives are deprived of this opportunity. Second, globalization generates conflicts inside and between nations concerning national regulations and their social institutions: for example, labor markets are not mobile and immigration policies are very restrictive. To the extent that technology applied to manufacturing becomes ever more standardized and diffused internationally, nations with different sets of values, norms, institutions and collective preferences will begin to compete head to head in markets for similar products. Under these circumstances, trade becomes confrontational when it implies the use of arguments that undermine basic national norms on such matters as labor practices and workplace regulations, legal practices, job security, the minimum working age, etc. Third, globalization is making it increasingly difficult for governments to offer social security, one of their main tools for maintaining social cohesion and national political support, especially with respect to liberalization policies.²⁸ In this sense, the most important challenge for the world economy will be to make globalization compatible with national socio-political stability, which means ensuring that international economic integration will not lead to national social disintegration.

Among developing economies options ranging from the establishment of a basic social safety net to Keynesian policies of the type that fulfill social welfare functions can be answer for avoiding social desintegration. Considering differences in the level of development among developing economies, liberalization policies for trade and capital, competitiveness policies and harmonization with international standards can have different or even oposite effects. While these policies in advanced developing economies can increase growth potentials and social mobility among workers, in less advanced countries they can undermine social cohesion where low skilled or less educated workers are concerned. Enhanced levels of social insurance for assuring better labor market outcomes can be provided in most countries within existing levels of spending (unemployment compensation, trade adjustment assistance, retraining programs, etc.) and important consideration since the provision of social insurance, through the establishment of social programs, has

²⁸ Dani Rodrik, *Has Globalization Gone Too Far?*, Institute for International Economics, Washington

historically played an important role in enabling multilateral liberalization and facilitating the explosion in the volume of world trade.

- **Globalization and Regionalism** At present there are around 80 regional agreements in force that offer privileged access to the markets of countries that make up their membership. The most prominent are the European Union (EU), the North American Free Trade Agreement (NAFTA) and MERCOSUR in the Southern Cone of Latin America. In fact, nearly all of the 130 members of the World Trade Organization (WTO) belong to at least one regional trade agreement (Japan, South Korea and Hong Kong are the only exceptions).

All of these regional trade agreements arose mainly in response to the liberal economic orientation of the global economy. Today's economic regionalism has a very limited political agenda. Most of the regional agreements are focused on expanding trade within their respective blocks by means of internal tariff reduction and the elimination of external barriers. The current movement toward economic regionalism responds to three impulses. First, the regional agreements of the 1980's and 90's have emerged as a strategy for the economic development of developing nations. The result of this strategy is that both developing economies and developed economies reach similar points of view and adopt similar policies toward market liberalization. It also becomes easier to coordinate governmental policies with respect to economic issues and fluctuations in the world economy. Second, regional trade agreements have proven themselves to be faster and simpler mechanisms for eliminating trade barriers than negotiations undertaken within a multilateral framework. States that have common borders have more immediate trade barriers to address, therefore regional negotiations offer greater probabilities for making progress and attaining rewards. Finally, the levels of public debt and budgetary deficits have constrained the possibilities for implementing Keynesian policies in many developing countries. In this sense, monetary policy might also have a relevant role to play in the more internationalized economies. In this

context, regional trade agreements could become very attractive because they provide political leaders with the ability to attribute certain levels of economic growth to their governmental policies. That is, regional trade agreements can be the fastest and most effective vehicle for immediate benefits.

Each of these three motivations for regional trade agreements suggest a deeper compatibility with continued global economic openness. They are clear efforts to widen and expand domestic markets through the creation of larger economic spaces. Therefore the three impulses should be looked upon as public policy tools and not public policy objectives,²⁹ since the ultimate goal is a “more gradual” insertion in the globalized economy and not merely attaining membership in a regional block.

Nonetheless, it is sometimes argued that membership in institutionalized regional integration schemes like the EU and NAFTA is a necessary precondition for the economic success of developing economies. This implies that they face the risk of being left behind, isolated from the dynamic of growing globalization. Clearly not all developing economies have participated in globalization: to date, economic dynamism has been regionally concentrated.

However, even if the type of regionalism represented by the EU, NAFTA and MERCOSUR is interpreted as contributing toward global free trade, dissident arguments see them as a trend toward the subdivision or fragmentation of the world economy and vehicles for pursuing the limited interests of their members to the detriment of non-member countries.³⁰

A different alternative to the traditional view of regionalism and its trade blocks is “open regionalism” (OR). ECLAC (1994) defined open regionalism as a process that reconciles integration with trade liberalization. That is to say that it makes

²⁹ John Ikenberry, *op. cit.*, pp 91 - 93.

³⁰ Rafael Urriola and Andrés Rebolledo, “Regionalismo, Multilateralismo y Coordinación en la Integración Económica,” in Francisco Rojas (ed.), *op. cit.*, p 108.

compatible the strategy of signing multiple trade agreements granting preferential market access with measures for trade openness based upon market signals.³¹

Open regionalism's main objective is achieving the reinsertion of national economies in global markets. Based upon a regional foundation, it posits taking advantage of complementarities and the opportunities offered by the geographic and cultural proximity that characterize the nations of the same region. In this sense, OR appears as another strategic option for certain groups of nations facing the challenges and opportunities of globalization. OR can also widen and deepen multilateral commitments in a regional context and become a building block for multilateral openness.

Ties with other regions, whether they are institutionalized or not, are therefore only one among many factors that can determine if a country participates successfully in globalization. But depending upon the motivation of international investors, factors such as macroeconomic stability, high rates of factor accumulation, a relatively non-distorting trade regime and openness toward international capital flows can be more important than any advantage that may stem from having privileged access to a large market. Economies that enjoy these characteristics can base their international position on multiple bilateral trade negotiations, allowing them to do without full membership in a regional or sub-regional pact and benefit from privileged access to specific markets instead. The advantage of pursuing this strategy is that it reinforces a country's autonomy in the design of its commercial policy. However, it requires a great deal of careful coordination in the negotiation and management of a network of bilateral agreements that operate simultaneously.

- **“Deglobalization”**: The financial crisis that originated in Asia has made manifest the need to reform the international financial order, and according to one observer, all of the proposals for reform can be divided into three basic approaches.³² The

³¹ CEPAL, *El Regionalismo Abierto en América Latina y el Caribe: La Integración Económica al Servicio de la Transformación Productiva con Equidad*. CEPAL Book Series No. 39, Santiago, 1994.

³² Walden Bello, “The Answer: De-Globalize,” *Far Eastern Economic Review*, 29 April 1999.

first calls for more transparency, especially with respect to the operation of hedge funds and mutual funds, and increased accountability. For those focusing their attention on transparency, the IMF is seen to be acting, in effect, as a lender of last resort to those countries that are willing to undertake financial reforms. These reforms include more liberalization, greater transparency, tougher bankruptcy laws to eliminate the moral hazard problem and more prudent regulations. The second approach focuses on capital controls, proposing them mainly for short term capital inflows and outflows through the utilization of transaction taxes, with Chile providing an example of an economy making an effort to manage short term capital inflows and Malaysia weighing in with its measures to curb capital outflows.

However, the proponents of “deglobalization” offer a much more radical critique, calling into question the development model itself and “the institutionalization of exports and foreign capital as the twin engines of economic growth.” They hold that the “fundamental flaw” of the model is that it encourages an indiscriminate integration into the global economy and an over-reliance on foreign capital for development. Deglobalization of the domestic economy, then, means “its reorientation toward greater reliance on the internal market; greater dependence on domestic capital resources; closer cooperation with neighboring economies to create protected regional markets” and, ultimately, “a lower rate, and more benign pattern, of growth that would generate less income inequality.”³³

The assumption is that deglobalized economies would be less susceptible to financial market turmoil and its spill over effects in the real economy. It is not altogether clear, however, that these economies would be able to strike a balance between globalization and deglobalization, and entirely possible that in their bid to isolate themselves from its excesses they would forego the benefits that globalization has to offer.

³³ Bello, *op. cit.*

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