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Policy Space: What, for What, and Where?

Jörg Mayer*

This article examines how developing countries can use, and enlarge, existing policy space, without opting out of international commitments. It argues that: (i) a meaningful context for policy space must extend beyond trade policy and include macroeconomic and exchange-rate policies that will achieve developmental goals more effectively; (ii) policy space depends not only on international rules but also on the impact of international market conditions and policy decisions taken in other countries on the effectiveness of national policy instruments; and (iii) international integration affects policy space through several factors that pull in opposite directions; whether it increases or reduces policy space differs by country and type of integration.

Key words: Policy space, economic development, multilateral agreements, development strategies

1 Introduction

Much of the current debate on the role of national policies in economic development concerns the concept of 'policy space' and focuses on the tension between international economic integration and the autonomy available to nation states to pursue policies that effectively support their economic development. As noted by Cooper (1968: 5), this tension arises from the dilemma of 'how to keep the manifold benefits of extensive international economic intercourse free of crippling restrictions while at the same time preserving a maximum degree of freedom for each nation to pursue its legitimate economic objectives'.

Recent concern about the tension relates mainly to two factors. First, the policy agenda which many developing countries pursued during the 1980s and 1990s did not result in the desired acceleration of economic development (see, for example, World Bank, 2005). Second, the greatly increased internationalisation of markets and the associated stronger impact of foreign factors on national development have in many instances weakened the effectiveness of domestic policies. These factors combined triggered a debate on the commonalities of successful growth strategies that could frame the conduct of economic policies and the desirability of more proactive policies in

* UNCTAD, Division on Globalisation and Development Strategies, Palais des Nations, Office E. 10020, CH-1211 Geneva 10, Switzerland (joerg.mayer@unctad.org). The article draws on the author's contributions to UNCTAD's *Trade and Development Report* 2006. He is grateful to Kevin Gallagher, Gerry Helleiner, Dieter Hesse, Detlef Kotte, Andrew Mold, Sheila Page, Ugo Panizza, Ken Shadlen, Adrian Wood, participants in a Geneva Trade and Development Workshop, and two anonymous referees for helpful comments on an earlier draft. The opinions expressed are solely those of the author and do not necessarily reflect the views of UNCTAD or its Member States.

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development strategies (UN Millennium Project (Sachs Report), 2005; World Bank, 2005; United Nations, 2007; Commission on Growth and Development (Spence Report), 2008). This debate remains unsettled, but in general it emphasises 'that there is no universal set of rules' and 'that growth entails more than the efficient use of resources' (World Bank, 2005: xii and 10).

However, it is often perceived that a desire to go beyond attaining the efficient use of resources and pursue more proactive policies is faced with a reduced number of effective policy instruments. For instance, the outcome of the Uruguay Round (UR) of multilateral trade negotiations has extended the scope of multilateral disciplines to include rules that impinge directly on domestic policies. This may explain why much of the debate on policy space is confined to trade policy and concerned with how the UR agreements restrict the sovereignty of nation-states to make their own policy decisions (for example, Gallagher, 2005; Brown and Stern, 2006; DiCaprio and Gallagher, 2006). Most of these studies voice the concern that UR disciplines prevent developing countries from following the most effective development policies. This may be interpreted as suggesting that developing countries could increase their current policy space only by opting out of at least some of their international commitments.

This article takes a different perspective. It examines how developing countries can effectively use existing national policy space, and indeed enlarge it, without opting out of international commitments. Its five main arguments are: (i) to be meaningful and pro-development, the context for policy space must extend beyond trade policy and include the many non-trade (particularly macroeconomic and exchange-rate) policies that will achieve developmental goals more effectively; (ii) policy space depends not only on international rules; rather, in a globalised world it also depends on the impact of international market conditions and policy decisions taken in other countries on the effectiveness of national policy instruments; (iii) international integration affects policy space through several factors that pull in opposite directions; whether it increases or reduces policy space differs by country and type of integration; (iv) policy-makers who choose to pursue more proactive policies and broad development objectives which privilege real economic variables (for example, real output and income growth) require instruments that allow (a) correcting for market and government failures, (b) managing boom-bust cycles, and (c) dealing effectively with external shocks; and (v) while the UR agreements have introduced restrictions, most of the policy space required to pursue proactive development policies is available and could be further enlarged by tightening disciplines in international monetary and financial relationships.

The theory of economic policy, dating back to Tinbergen (1952), forms the methodological framework of the following examination. While this approach may not be applicable as a blueprint for contemporary policy-making (van Velthoven, 1990), its basic concepts remain useful. Thinking of policy-making in terms of targets, instruments, other variables and a model that describes the relationship between them is widespread in public debate and allows consideration of the operational content of the concept of policy space.

The next section aims at clarifying what is meant by the concept of policy space. Section 3 examines for what purposes a broad range of policy instruments may be required if policy-makers choose to pursue more proactive development strategies. It maps the linkages between instruments and targets so as to determine broad instrument-target assignments in such a strategy. Section 4 uses this mapping to identify areas where actions at national and international levels might allow developing countries to use their existing policy space more effectively and to increase it without opting out of international commitments. Section 5 provides country-specific examples of how the effectiveness of specific domestic instruments has been affected by international forces at specific times, and Section 6 concludes.

Although not within the scope of this article, it should be noted that the mere fact of having policy space does not imply that it is always put to good use. Some developing countries have used their policy space effectively and have been rewarded with accelerated development, while others have been less able to capitalise on existing policy autonomy. Effective use requires policy-makers to have a vision of where they want to take an economy. This, in turn, necessitates the formulation of a national development strategy that has a clear understanding of local capabilities, constraints and opportunities, and that identifies clear objectives, spells out how policy instruments will be deployed to attain them, and establishes effective monitoring mechanisms to determine whether targets are being met. Widespread scepticism about the institutional capacity of some countries to manage a proactive development strategy cannot be ignored. Part of this scepticism is clearly justified, given the poorly performing institutional set-ups in a number of countries.

It may be useful to emphasise also what the article is not intended to do. First, it provides no new theoretical insights on consistent policy-making. Rather, it draws on the literature on policy-making in developing countries (particularly Rodrik, 2004; and Stiglitz et al., 2006) and examines how the type of integration proposed there relates to the policy-space debate. The article focuses on these two studies because the integration strategy they propose implies a much more proactive role for economic policies than those suggested by others. Hence, its findings may be considered the outcome of an extreme case scenario. Second, the article does not present a country case study, which would be the only way to identify with reasonable precision how the effectiveness of a feasible set of policies is influenced by the structure of the domestic economy, a given global economic situation, and a given domestic and global institutional environment. While this would be an interesting area for further research, such an assessment is necessarily determined by country- and time-specific factors.[1]

2 National policy space in an integrating economy

The theory of economic policy – initiated by Tinbergen (1952), elaborated from a macroeconomic interdependence perspective by Cooper (1968) and Bryant (1980), and recently also used in the policy-space debate by UNCTAD's *Trade and Development Report* 2006 and Akyüz (2007) – has been an important basis for addressing the effectiveness of policies in the evolution of a national economy.[2] In spite of the many

1. A possible methodology for such an assessment could be 'growth diagnostics' as explained by Hausmann et al. (2008).
2. The theory of economic policy only addresses what Tinbergen (1952) called 'quantitative' economic policy, which is distinct from the 'qualitative' framework in which policy-makers operate. The latter describes a country's economic and political institutional arrangements that have a strong impact on

arguments[3] against applying that theory as a blueprint, both policy-makers and economists who provide policy advice generally adopt, explicitly or implicitly, its basic ingredients. Those ingredients are: (i) a set of instruments that are subject to direct control by policy-makers, (ii) a set of targets that describe the evolution of the national economy and (iii) a model which describes the economic relationships between instruments and targets, as well as the choices available to policy-makers to attain desired values of the targets by applying specific instruments. Given that a multitude of instruments have an impact on the chosen targets and that often there are significant time-lags before such impacts become measurable, it is useful also to include a number of intermediate targets in the model in addition to a small number of ultimate target variables.[4] There are two important rules of the theory of economic policy: (i) the number of policy instruments must be at least as great as the number of targets if all targets are to be attained, and (ii) in case of trade-offs between target variables, policy-makers must use a social welfare function to decide which combination of instruments maximises the degree to which a consistent set of targets can be attained.

Policy-makers in closed economies have full sovereign command over policy instruments, but they may not be able to control specific policy targets effectively. First, potential trade-offs in the effectiveness of different instruments, as well as in the objectives sought, make it difficult to combine the available instruments in a way that would enable all targets to be attained simultaneously (van Velthoven, 1990). Second, instruments can be used only within specific boundaries (Bryant, 1980: 173). For example, there is a limit to how far nominal interest rates can be lowered. Third, the relationships between policy instruments and targets are often unstable, and knowledge and information about these relationships are usually incomplete. This problem is particularly acute in developing countries where policy aims at achieving structural change and thus involves a continuous adaptation of targets, instruments and behavioural relations rather than a routine use of a given instrument-target relationship. This need for constant adaptation makes it desirable to have available as many effective policy instruments as possible (Cooper, 1968: 153-4).

To analyse instrument-target relationships in an internationally integrated economy, it is useful to distinguish *de jure* sovereignty, which involves the formal authority of national policy-makers over policy instruments, and *de facto* control, which involves the ability of national policy-makers to effectively influence specific targets through the skilful use of policy instruments (Cooper, 1968: 4; Bryant, 1980: 149-50). On this basis, national policy space can be defined as the combination of *de jure* policy sovereignty and *de facto* national policy autonomy.

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incentives and on the behaviour of both policy-makers and individuals, and thus on the structural characteristics of instrument-target relationships.

3. Van Velthoven (1990) discusses four major criticisms: (i) rational expectations, suggesting policy ineffectiveness, (ii) the Lucas critique, suggesting that the coefficients of the model describing instrument-target relationships will in part reflect the specific combination of instruments applied during the period over which they are estimated, and thus need not be stable, (iii) information constraints and decision costs, which further reduce the certainty with which a given set of instruments can attain the targets that define a specific level of social welfare, and (iv) public choice issues which question whether public-sector decision-making is an adequate reflection of citizens' preferences.
4. For example, controlling investment-to-GDP ratios or technology and education levels can be intermediate targets for achieving income growth.

This distinction suggests that international economic integration affects national policy space through several forces that pull in opposite directions. The process of integration into the global economy restricts national policy space both in terms of a reduction in the number of available instruments as a result of legal commitments to international rules and practices (i.e. constraints on *de jure* policy sovereignty), and in terms of the reduced effectiveness of macroeconomic instruments (i.e. constraints on *de facto* policy autonomy). At the same time, integration enlarges national policy space in terms of *de facto* control because (i) multilateral rules and disciplines enable a co-ordinated response to cross-border disturbances and prevent policy-makers in countries that can have a disproportionately large impact on the evolution of other economies from adopting discriminatory or beggar-thy-neighbour policies, thus restoring part of the effectiveness of domestic instrument-target relationships in internationally less influential countries; and because (ii) integration into a larger market increases the effectiveness of many structural policies, particularly those whose effectiveness strongly depends on scale economies or the disciplines of international competition.

The workings of these different forces, which make policy space an issue of finding the right balance, can be considered more precisely as follows:

(i) Integration into international economic relationships weakens *de facto* control over national economic development by allowing foreign actions and conditions to influence national macroeconomic policy targets.[5] This reduced effectiveness in the ability to control national policy targets is most prominent in monetary policy. As national money and capital markets are joined by international flows of funds, interest rates tend to converge across countries. This can create trade-offs between attaining internal or external targets. For example, in response to changes in international financial markets domestic policy-makers may be compelled to change the level of the domestic interest rate because the *relative* difference in interest rates affects cross-border capital movements. However, such a change may result in an *absolute* level of the interest rate that is inappropriate for attaining domestic policy targets. Moreover, with an open capital account both the exchange rate and the interest rate are potential policy instruments, but only one of them can actually be employed independently.[6]

(ii) Multilateral rules and disciplines, as well as commitments resulting from bilateral agreements, reduce *de jure* sovereign control over policy instruments. For example, the conditionality attached to assistance from the international financial institutions reduces the autonomy of governments to determine the size of public expenditures, and WTO agreements reduce the scope for Member States to impose trade-related performance requirements on the granting of subsidies to domestic manufacturers.

These two sources of external constraints on national policy space overlap and reinforce each other. On the one hand, integration into international markets reduces the number of instruments controlled by policy-makers much in the way sovereignty is circumscribed by enhanced international rules and disciplines. On the other hand, international rules and disciplines weaken the influence of national policy instruments

5. Akyüz (2007), following Cooper (1968) and Bryant (1980), discusses the impact of openness on macroeconomic policy autonomy in a similar way.
6. For the distinction between potential and actual policy instruments, see Bryant (1980: 13).

over national policy targets by promoting economic integration. This weakening of sovereignty and of the effectiveness of national instruments over national targets must be weighed against the gains from integration into international markets and participation in the system of multilateral rules and disciplines.

(iii) While *de facto* integration into international markets reduces the effectiveness of national macroeconomic policies, it can improve the effectiveness of many structural policies that are of crucial importance for developing countries. Increasing returns to scale on an industry-wide basis and enhanced technological upgrading are the two main channels that, compared with policies in closed economies, make outward-oriented policies more effective in establishing competitive industries, thus improving the effectiveness of national sectoral and technology policies. For example, technological upgrading in developing countries often depends on the availability of foreign technologies embodied in imported capital goods, particularly during the initial stages of industrialisation. Economic integration facilitates access to foreign technologies, and the foreign exchange earned from exporting alleviates the balance-of-payments constraint. Both these mechanisms combine to reinforce the effectiveness of a country's sectoral and technology policies to build productive capacity and spur productivity growth.[7] Regarding financial integration, access to international financial markets enables domestic firms to finance investment under internationally competitive conditions, which increases the effectiveness of national investment policies.[8]

(iv) Multilateral rules and disciplines can also improve national policy effectiveness.[9] Globalisation provides an opportunity for policy-makers in influential economies to use beggar-thy-neighbour policies. They may be tempted to employ commercial, macroeconomic or exchange-rate policies in pursuit of specific national objectives – such as attaining mercantilist goals or postponing the adjustment of internal or external imbalances – which reduce the effectiveness of national policy instruments in other countries. In the absence of multilateral disciplines and co-operation, retaliatory action by adversely affected countries could lead to disruptions in international economic relations that might leave all countries worse-off.

Multilateral co-operation and disciplines can also help maximise global public goods. Countries might refrain from undertaking unilateral trade liberalisation – for fear of adverse effects on their balance of payments and employment – even when they believe that doing so would bring efficiency gains. However, they might be willing to undertake multilateral trade liberalisation because the principles of reciprocity and non-discrimination underlying multilateral rules give relatively weak countries better protection than they would be able to obtain on their own by negotiating bilateral

7. The timing of integration into international markets is an important element of whether increasing returns to scale can be captured. According to Amsden (2001), disposing of significant manufacturing experience is an important condition for the mastering of technology by learning and assimilating imported technology and, thus, withstanding import competition following international integration.
8. This is true, however, only under normal circumstances. In periods of international economic upheaval foreign-currency-denominated liability positions of financial and non-financial firms can seriously constrain domestic macroeconomic policy options.
9. This and the following two paragraphs partly follow Akyüz (2007).

agreements or staying out of any multilateral commitments altogether.[10] As far as systemic stability in international money and finance is concerned, it is likely that emerging economies will remain vulnerable to currency and financial crises as long as the currencies of the major industrial countries remain subject to large gyrations. By contrast, macroeconomic policy co-ordination and multilateral monetary and financial disciplines that would ensure stable and well-aligned exchange rates among the key currencies would shield weaker and smaller economies from adverse impulses originating from monetary and fiscal policies in the major countries.

For global collective action to be acceptable to all parties, it must result from a bargaining process based on the full, equal and voluntary participation of all the parties concerned. However, there is a natural inclination, particularly on the part of internationally powerful countries, to shape multilateral arrangements in a way that gives them maximum flexibility to pursue their own goals while restricting the degrees of freedom for others in areas of conflicting national interests. Countries that feel disadvantaged by the way multilateral rules and commitments are formulated and implemented can, in principle, choose not to participate in or leave the multilateral arrangements in question and conduct international relations on a bilateral basis. But countries with little power internationally (i.e. the vast majority of developing, as well as many developed, countries) will not be well-advised to follow this route, because coercive action is likely to be even stronger in bilateral relationships with major economic and political powers.

To sum up, the tension between international economic integration, on the one hand, and the degree of autonomy available to a country to implement policies that effectively influence its economic performance, on the other, is governed by both its *de facto* integration into international markets and its *de jure* integration into supranational governance structures. How to determine the right balance between maintaining flexibility in national economic policy-making and reducing it through multilateral disciplines and collective governance remains a contentious issue. On the one hand, the absence of multilateral disciplines can disrupt international economic relations and/or bias them in favour of those countries that wield substantial economic or political power. On the other hand, an increasing extension of legally binding external constraints on national economic policies, including multilateral rules and obligations established without the full participation of all countries concerned and biased against the interests of some groups of countries, would unduly impinge on the availability or effectiveness of national policy instruments.

However, there is no *quantifiable* single balance between multilateral disciplines and national policy autonomy that suits all countries or applies across all spheres of economic activity. As further discussed in Section 6, individual countries need to consider several factors when they evaluate the specific trade-offs of international integration they face.

10. Indeed, the fact that multilateral commitments also bind strong partner countries to abide by the rules may be valued by weak countries more than their gain in market access, which according to Polaski (2006) now is likely to be fairly small and concentrated in a handful of countries.

3 Linking policy instruments and targets in an integrating economy

One difficulty in applying the instruments-targets approach to real-life policy-making is limited knowledge about the incentive and behavioural structures of individuals, as well as the ways in which policy-makers react to changes in the structure of the economy or to external shocks. Both these aspects, which may be considered as forming part of what Tinbergen (1952) called the 'qualitative' framework of an economy, are highly country- and time-specific. Getting better knowledge of this qualitative framework is likely to be one element of 'development as a discovery process' (Hausmann and Rodrik, 2003).

Another difficulty is the absence of a consensus on how the process of growth and development is generated and sustained, and how policy instruments and targets relate to each other in this process. Most development concepts consider stable and sustained real income growth to remain the most important target of economic policy in developing countries.[11] But rival concepts embody significantly different analytical views with attendant controversies as to what targets policy-makers should pursue, how best to describe instrument-target relationships, and how *de facto* and *de jure* international integration impacts on the (effective) use of national policy instruments.

Given these differences, it is useful as a first step to map, if only in an illustrative manner, what instrument-target relationships try to attain in different policy areas. This section develops such a map, which the subsequent section uses to determine where and in what direction national policy strategies and the scope of multilateral rules and disciplines could be altered to increase the effectiveness of national policies for attaining growth and development targets in an integrating economy. As already mentioned in the Introduction, this mapping is based on what Stiglitz et al. (2006) call the 'heterodox perspective', because the integration strategy proposed from this perspective implies a much more proactive role of economic policies than, for example, World Bank (2005), the Sachs Report or the Spence Report. Hence, the findings of this article may be considered the outcome of an extreme case scenario.

Some of these instrument-target relationships are controversial – as are those of alternative perspectives – and their developmental effects clearly depend on country- and time-specific factors. Thus, they should not be seen as a blueprint for development strategies but rather as a framework that identifies objectives and spells out how policy instruments can be deployed to attain them; this, in turn, allows determining which and in what way specific instrument-target relationships are affected by *de facto* and *de jure* integration.

The heterodox perspective criticises the instrument-target relationships of the reform agenda that many developing countries pursued during the 1980s and 1990s as being too narrowly focused on monetary stabilisation, emphasising intermediate targets (monetary stabilisation) instead of final ones, and using too few instruments (mainly monetary and fiscal policies) because of an excessive focus on price stability and allocative efficiency as the key conditions for economic growth. It argues that relying on monetary stabilisation and efficient use of resources ignores the interrelationship

11. While recognising that there are broader concepts of development, this article is limited to a focus on longer-term economic growth.

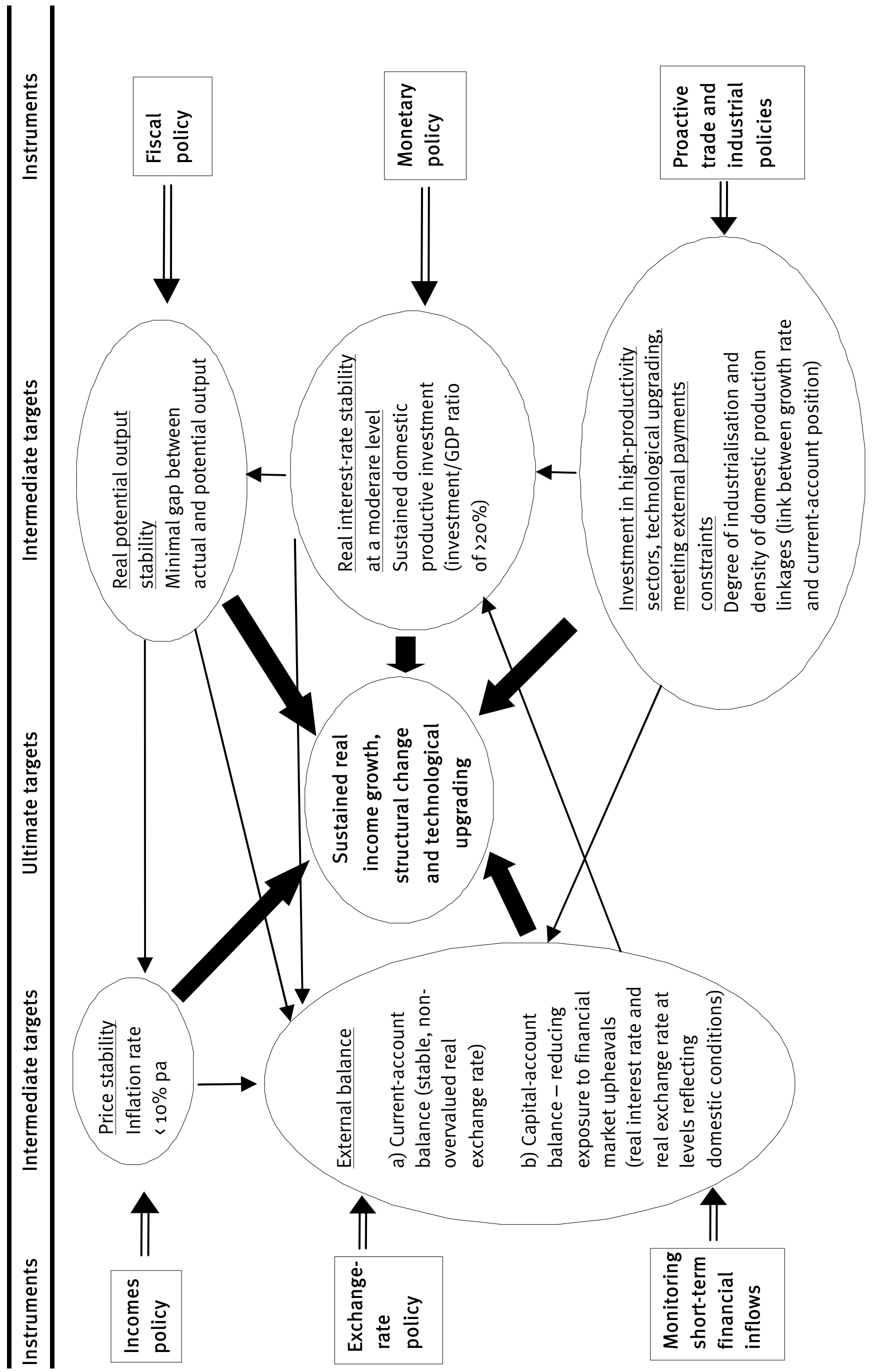
between stabilisation and growth, as well as the potentially adverse impacts of international market forces – unleashed through broad-based trade and financial integration – on stabilisation and growth. Furthermore, it criticises this approach for considering its policy agenda as a blueprint, with insufficient attention given to country-specific conditions. In this sense, the heterodox perspective does not prescribe a different, but still globally applicable, blueprint. Rather, it represents an alternative perspective on policy targets and instrument-target relationships whose operational details and requisite reform prescriptions will vary across countries depending on local economic and institutional conditions.

The heterodox perspective sees the dynamics of production structures as the engine of growth and development. Hence, governments are to pursue macroeconomic policies that combine stabilisation with growth promotion, and adopt trade and other structural policies that encourage investment (both domestic and foreign) which generates new products and new production processes and facilitates the creation of linkages among domestic firms and sectors. It argues that financial liberalisation can rapidly give rise to speculative short-term financial flows through which events on international markets and policies adopted by other countries can have a disruptive effect on domestic policies. Hence, there is a strong emphasis on proactive macroeconomic and structural policies to stimulate productive investment, move an economy towards high-productivity sectors and activities, and reduce its vulnerability to potentially adverse effects from financial liberalisation. While policies should aim to achieve efficiency gains, they are considered unlikely to spur growth unless they also strengthen incentives for innovative investment and address market and government failures that undercut efforts to accumulate capital and boost productivity.

Figure 1 suggests a map of instrument-target relationships that aim at maximising the effectiveness of domestic policy instruments in attaining sustained real income growth, structural change and technological upgrading. Section 3.3 below discusses how multilateral rules and disciplines can support this effort.

It is clear that the map cannot fully reflect the complexity of development policies. For example, trade-offs between instruments and/or targets can have important effects on outcomes, but this is not reflected here. While the map helps to clarify the specific purpose and potential contribution of each instrument, it needs to remain at a rather general level. Individual countries will need to calibrate these broad instrument-target assignments to their specific economic and social conditions, national preferences and institutional set-ups. Combined with the subsequent narrative, the map is nonetheless useful in providing broad indications on a set of policy instruments and targets available to conduct a consistent and co-ordinated development strategy that aims at sustained real income growth, structural change and technological upgrading. The figure reflects the primary link between instruments (in squares) and intermediate targets, as well as quantitative measures of these targets (encircled), through double-line arrows, while single-line arrows indicate indirect links. Thick arrows mark links between intermediate targets and the ultimate targets of sustained real income growth, structural change and technological upgrading (encircled bold).

Figure 1: Instrument-target relationships from a heterodox perspective



3.1 Macroeconomic and exchange-rate policies

The heterodox perspective considers macroeconomic stabilisation and growth policies to be closely interrelated. On the one hand, the monetary and fiscal policy mix influences the behaviour of real interest rates, exchange rates, output, wages and asset prices, which in turn strongly influences investment and savings decisions, as well as the international competitiveness of a country's enterprises. On the other hand, aggregate income growth fosters household savings and, through the automatic stabilisers, fiscal accounts, as well as productivity growth that enables non-inflationary wage growth. Hence, in order to be conducive to productive investment and income growth, macroeconomic stabilisation should be targeted at real, rather than monetary, variables (such as real output, real interest and real exchange rates) and should aim at encouraging and supporting the creation and expansion of internationally competitive productive capacity.

The heterodox perspective sees fiscal stabilisation as a key instrument for achieving overall macroeconomic stability, which in turn provides the foundation for price and exchange-rate stabilisation. It does not view low inflation itself as a policy target because, owing to uncertainty about the often only weak link between inflation and real variables, it is preferable to focus directly on observable real variables. Moreover, moderate inflation rates are considered unlikely to impede economic growth. According to a wide range of studies, inflation is detrimental to growth only if it is in excess of a certain threshold. While there is no agreement on the level of that threshold, it is often considered to be around 10% per annum.[12] In addition to the stabilisation effects stemming from the monetary and fiscal policy mix, the heterodox perspective recommends achieving price stability through an incomes policy (i.e. controlling wage growth as a source of cost inflation by coercing or persuading employers and employees to restrict their price and wage increases within a given level of overall productivity growth).

With incomes and fiscal policies being the main instruments to control inflation, monetary policy can be targeted at economic growth. The following are its immediate targets from a heterodox perspective: maintaining interest rates at levels that provide domestic credit on terms and conditions offering appropriate incentives for productive investment; maintaining a competitive and stable real exchange rate; and ensuring the development and stability of the domestic financial system. At the same time, balance-sheet vulnerabilities (for example, caused by liability dollarisation and maturity mismatches) must be minimised to foster financial-sector stability. Financial development, supported by banking and non-bank financial regulations, safeguards most domestic control over policy variables if it creates and consolidates domestic-

12. Khan and Senhadji (2001) indicate a threshold of 11-12% per annum for developing countries; they also discuss the findings of earlier studies which mostly found higher threshold levels. The rationale for allowing moderate inflation rates is also based on the strongly adverse economic impact of deflation and the fact that monetary policy is ineffective when an economy is in deflation. Moreover, there are important trade-offs between rapid disinflation and growth, because with rapidly falling inflation high nominal interest rates quickly translate into high real interest rates that discourage productive investment and limit growth.

currency-denominated intermediation instruments (for example, bank loans, corporate bonds, securitised assets) that facilitate productive investment.

The heterodox perspective argues that the volatility and pro-cyclical character of short-term capital flows requires the prudential management of such flows in order to preserve macroeconomic stability and allow policy-makers to use restrictive monetary policy during economic upswings and avoid excessively contractionary policies during slowdowns. The key objective of such management is preventing the cumulative build-up of foreign liabilities that can be easily reversed; in other words, preventing cyclical upturns in external financing from triggering excessive increases in external credit to the domestic private sector, preventing capital inflows from causing real exchange-rate overvaluation, and controlling mismatches in the currency denomination of assets and liabilities in the domestic financial sector. Related instruments can be indirect (for example, prudential regulations) or direct (reserve requirements or taxes on external financing, direct regulation of portfolio flows). Measures adopted in the 1990s by Chile and Colombia are often cited as examples of direct instruments (Epstein et al., 2004).[13] However, in order to make the use of these instruments effective, sustainable monetary and fiscal policies must underpin this prudential management.

In terms of choosing the exchange-rate regime, the heterodox perspective advises against adopting so-called 'corner solutions' (i.e. fixed pegs or full floating). In particular, it opposes use of the exchange rate as an instrument for disinflation. It sees maintaining a sustainable current-account position and stability of the real exchange rate at a level that preserves domestic firms' international competitiveness as the main targets of exchange-rate policy. Choosing soft pegs or managed floating as an exchange-rate regime facilitates achievement of these policy targets.[14]

3.2 Integration and structural policies

Regarding the objective of *de facto* integration, the heterodox perspective emphasises support for the development and continuous upgrading of productive capacity while meeting intertemporal budget constraints, rather than narrowly aiming at efficiency gains from aligning domestic with international prices. This is to be achieved through strategic integration which, compared with rapid and broad-based liberalisation, is a more measured, selective and policy-driven strategy.

The heterodox perspective considers the creation of the technological capability to produce competitively goods previously purchased abroad to be a natural feature of

13. The IMF Articles of Agreement allow such controls. Art. VI section 3 (Controls of Capital Transfers) states 'Members may exercise such controls as are necessary to regulate international capital movements …'. IMF policy advice may become more favourable towards controlling capital flows. According to the IMF's Independent Evaluation Office (2005: 6) 'the IMF has learned over time on capital account issues' and 'the new paradigm … acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows'. So far, this has not yet been consistently reflected in policy advice because of 'the lack of a clear position by the institution'.

14. As outlined by Bradford (2005: 5-6), choosing managed exchange-rate regimes, combined with selective capital controls, also allows for some monetary policy autonomy. Thus, it avoids the impossible trinity, i.e. the impossibility of having a fixed exchange rate, a completely open capital account and full monetary policy autonomy at the same time.

economic development. However, due to the multitude of information and co-ordination failures associated with investment and productivity growth, relying on the incentives generated from allocative efficiency may not suffice (Rodrik, 2004). Rather, the heterodox perspective emphasises the need for proactive trade and industrial policies to foster nascent industrial activity and promote technology transfer and adaptation. The range of instruments designed to attain such targets include performance requirements for foreign investors, subsidies conditional on export performance to encourage the international competitiveness of nascent domestic manufacturing, flexible use of compulsory licensing for the domestic use of protected foreign intellectual property, a flexible import-tariff policy that modulates applied tariffs on particular manufacturing sectors around a stable average level, and many more.

Rodrik (2004) argues that the aim of proactive trade and industrial policies is not to pick winners, but to identify and discipline underperforming firms. Thus, the establishment of clear operational goals, time horizons and sunset clauses, as well as the adoption and effective monitoring of observable performance criteria, are critical to the success of this strategy. In a sense, the enforcement of performance requirements, particularly those related to productivity gains as imposed by the disciplines of the international market, represents the 'stick' that complements the 'carrot' provided by the creation of rents from productivity-enhancing investment supported by temporary subsidies and protection. It is by constraining the use of such trade-related performance requirements that, from a heterodox perspective, the UR agreements most seriously reduce developing countries' policy space.

3.3 Institutions

Regarding institutional arrangements, the heterodox perspective emphasises that government action is a strategic complement to markets. Juxtaposing government and markets, or government failures and market failures, would be misleading. Rather, institutions must introduce corrective measures against both market failure and government failure. Governments need to be made accountable, not bypassed. Institutional change should aim at improving checks and balances on government discretion, addressing information and co-ordination externalities, monitoring instrument-target relationships, and managing reciprocal control mechanisms designed to minimise abuse of economic rents that are inherent in the dynamics of structural change in production and trade. Strategic collaboration between the government, business organisations and institutions of learning and innovation is an important instrument to this end.

The heterodox perspective sees the main target of *de jure* integration as reducing exposure to adverse external effects, including protection from beggar-thy-neighbour policies adopted by other countries. This target is closely related to the overall rationale for multilateral rules and commitments, discussed in Section 2 above.

4 National and international measures to enlarge policy space

Based on the mapping of instrument-target relationships in Figure 1, Table 1 links broad policy areas to levels of policy-making. The table aims at indicating where policy-makers could take measures to use existing policy space more effectively and further enlarge their current space without opting out of international commitments. The text in square brackets and italics indicates how the constraints and the means of alleviating them relate to the instrument-target relationships in Figure 1. The basic point of the table is to show that such measures would imply a reassessment of instrument-target assignments at the national level and a rationalisation of multilateral rules and disciplines at the international level. This rationalisation would entail tighter, rather than looser, multilateral disciplines in money and finance. It would aim in particular to control wide deviations from underlying conditions of the nominal exchange rates among those countries that have the greatest impact on international monetary and financial stability.

De jure constraints on developing countries' policy space are the most pronounced for structural policies.[15] The UR agreements account for some of this restriction.[16] Nevertheless, these agreements have left some policy space.[17] While the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPs) risks pre-empting or stifling countries' ability to develop domestic technological capabilities, it does allow flexible use of compulsory licensing. The Agreement on Trade-related Investment Measures (TRIMs) makes it difficult to link investment support to export-related disciplines aimed at withdrawing support from producers who do not achieve international competitiveness within a pre-defined period of time. But measures regulating foreign direct investment that do not violate national treatment or impose quantitative restrictions continue to be consistent with WTO rules. The Agreement on Subsidies and Countervailing Measures implies a significant tightening of disciplines, but some subsidies have been tacitly allowed, with neither developed nor developing countries challenging them. There is disagreement as to whether the remaining permitted subsidies are sufficient to allow support for industrial development, but it is clear that fiscal cost is a major constraint on many developing countries' use of such subsidies. Pursuing a flexible tariff policy remains possible for many developing countries, although this potential has remained largely unexploited. In this respect, possible constraints on flexible tariff policies resulting from the Doha Round negotiations might reduce potential, but not current, policy space. Developing countries appear to accord greater importance to securing constraints on developed countries'

15. See Gallagher (2005) for a detailed discussion of the issues addressed in this paragraph. It should also be recognised that there are many informal constraints; for example, aid-dependent countries often lack the confidence to carry out policies that might conflict with the interests of donors.
16. DiCaprio and Gallagher (2006) analyse WTO case law and discuss in detail where the policy space of individual developing countries has been affected by the enforcement of the commitments taken through the UR agreements.
17. This is true particularly for least developed countries, for which transition periods have been extended; for example, for TRIPs until at least 2016 and for TRIMs until at least 2020.

Table 1: Constraints on developing countries' policy space and measures for its enlargement

	Sources of current restrictions on national policy space	**Measures for preserving or enlarging existing policy space without opting out of existing commitments**	
		National measures	**International measures**
Macroeconomic policies	*De facto* (particularly financial) integration [*Reduces effectiveness of domestic policies*] Loan conditionality of IFIs & aid conditionality of donors [*Reduces number of available policy instruments*]	Reassessment of policy targets & instrument-target relationships, from emphasising monetary stabilisation towards emphasising real economic variables & the interrelationship between stabilisation & growth-enhancing policies [*Increases the number of available instruments allowing for better management of boom-bust cycles & greater effectiveness of monetary, trade & industrial policies to achieve ultimate targets of structural change & sustained growth*]	Tighter multilateral disciplines over macroeconomic & exchange-rate policies of countries with greatest impact on global monetary & financial stability [*Reduces extent of potential external monetary & financial shocks & improves effectiveness of macroeconomic policies*] Better macroeconomic & exchange-rate policy co-ordination between key currency countries [*Prevents unsustainable global imbalances & enlarges exchange-rate policy autonomy for countries with little systemic influence*] Regional monetary & financial co-operation among developing countries [*Second-best option if multilateral solutions cannot be found*]

Table 1: cont'd

	Sources of current restrictions on national policy space	Measures for preserving or enlarging existing policy space without opting out of existing commitments	
		National measures	International measures
Structural policies: mainly trade & industrial policies	*De jure* trade integration through both multilateral &, in particular, bilateral & regional North-South agreements [*Reduces number of available policy instuments*]	Reassessment of policy targets & instrument-target relationships, from emphasising maximisation of export market access & FDI inflows towards maximising creation of domestic value added & linkages [*Strategic integration makes contribution of trade & industrial policies to real output growth & structural change more effective*]	Avoiding further tightening of WTO disciplines on developing countries' industrialisation strategies & of multilateralisation of WTO-plus rules on intellectual property rights, investment, government procurement, etc. [*Avoids further reductions in number of available trade & industrial policy instruments*]
		Avoidance of additional constraints from bilateral trade & investment agreements [*Avoids further reduction in number of available trade & industrial policy instruments*]	Tighter WTO disciplines on developed-country use of trade contingency measures (e.g. zeroing in antidumping) & agricultural support & protection [*Better balance between developed & developing countries regarding reduction in number of available trade & industrial policy instruments*]
Institutions	Developed countries' dominance of multilateral norm-setting & their use of their own institutional settings as a blueprint for national institutions in developing countries [*Constrains institutional & policy diversity*]	Reorientation from efficiency-enhancing to growth-enhancing institutions [*Allows dealing with both market & government failures & makes proactive trade & industrial policies more effective*]	Reassessment of global economic governance structure to allow developing countries to become proactive norm-setters [*Favours institutional & policy diversity*]

agricultural policy space than to maintaining their own policy space for industrial tariffs. Meanwhile, North-South economic integration agreements have resulted in further *de jure* constraints, as discussed in the preceding section.

It is through supposedly sovereign decisions that developing-country policy-makers sign on to the commitments of international trade agreements that reduce *de jure* policy space. This may partly reflect some preference for short-term benefits over autonomy in deciding on their long-term policy options.[18] But different degrees of influence between developed and developing countries on globalisation trends and global economic governance often confront policy-makers with difficult trade-offs. Regarding the commitments stemming from the UR agreements, Finger and Nogues (2002) note that, at the end of the negotiations, developing countries were faced with the choice of accepting what was proposed or risking being marginalised in the international trade regime.[19] As for engagement in North-South integration agreements, Baldwin (1997) notes a domino effect: existing North-South preferential agreements tempt non-members to join so as not to lose out on access to sizeable export markets and sources of FDI. Hence, while engaging in international commitments may be a 'sovereign' decision, there is often little alternative.

Preserving the remaining multilateral *de jure* policy space for developing countries to undertake structural policies implies that, at the international level, moves to multilateralise bilateral and regional trade agreements should not extend to their WTO-plus commitments. It also implies that a potential further tightening of WTO rules should emphasise greater discipline on developed countries' use of trade contingency measures (for example, the practice of zeroing in anti-dumping) and of agricultural support and protection. At the national level, it would imply a reassessment of the relative benefits stemming from greater export-market access and FDI inflows, on the one hand, and flexibilities in policies designed to maximise the creation of domestic linkages and value added, on the other.

In spite of exposing the domestic economy to a number of adverse influences originating in international markets, *de facto* international integration preserves significant national policy space. As outlined in the previous section, fully exploiting this space requires a reassessment of policy targets and instrument-target relationships at the national level. Such a reassessment, including the use of a greater number of policy instruments, would aim at pursuing more proactive macroeconomic and structural policies, while reducing the vulnerability of the domestic economy to the adverse spillover effects of international monetary and financial disturbances.

The developmental effectiveness of macroeconomic and structural policies would be strengthened by a reorientation of developing countries' institutional arrangements

18. Depending on the relative size of the costs and benefits involved, this may not imply an overall negative net benefit, particularly to the extent that policy-makers can denounce such agreements after benefits have started to accrue while costs have not yet set in, or because they were not intending to use the policy space forgone.

19. According to Finger and Nogues (2002: 334), influential developed countries had announced that they would withdraw from the General Agreement on Tariffs and Trade as soon as the WTO came into existence. This implied that a country that did not accept the 'grand bargain' of the UR agreements would not have enjoyed protection from discriminatory treatment, either from the new WTO or the old GATT rules and regulations.

from efficiency-enhancing towards growth-enhancing institutions (Khan, 2007); in particular, by deploying reciprocal control mechanisms for the effective management of economic rents associated with proactive trade and industrial policies.

The effectiveness of reassessing policy targets and instrument-target relationships at the national level will be strengthened, in particular, by adopting appropriate measures at the international level aimed at tackling the root causes of international monetary and financial disturbances, especially the lack of a viable multilateral monetary and financial system that would balance in a symmetric fashion the adjustment obligations of surplus and deficit countries and help avoid financial markets driving the external accounts of countries into unsustainable imbalances. Unlike the multilateral trading regime, current monetary and financial arrangements are not organised around a multilaterally negotiated set of rules that would be binding and enforceable for all participants. Existing rules do not seem to offer appropriate instruments for tackling major global financial problems such as exchange-rate volatility, sizeable and prolonged current-account imbalances, and the dominance of short-term financial flows over long-term ones.

The Bretton Woods system contained multilateral disciplines to control two main channels of exchange-rate instability (Akyüz, 2007). First, restrictions over short-term arbitrage flows sought to limit interest-rate arbitrage, and hence the scope of markets to generate unexpected and erratic exchange-rate movements. Second, the exchange-rate arrangement implied obligations for countries to maintain their exchange rates within a narrow range of agreed par values, thus preventing beggar-thy-neighbour policies based on competitive devaluations; but it also allowed them to change their par values under fundamental disequilibrium. These arrangements allowed the Bretton Woods system to maintain a balance between national policy autonomy, on the one hand, and multilateral disciplines, on the other. Sacrificing formal monetary autonomy was rewarded by stability in the financial markets and better foresight in international trade and in related decisions concerning investment in fixed capital.

Following the demise of the Bretton Woods system, strengthened surveillance over national policies in IMF Article IV consultations has sought to compensate for the lack of multilateral disciplines on exchange-rate policies. However, such disciplines have not extended to those countries whose policies have the greatest impact on global monetary and financial stability. Given that the IMF can exert meaningful disciplines only through conditionality built into loan agreements, its policy oversight is confined primarily to its poorest members, who need to draw on its resources because of their lack of access to private sources of finance and, occasionally, to emerging economies experiencing currency and financial crises. However, IMF surveillance has been unable to prevent exchange-rate gyrations and wide divergences from underlying conditions, unsustainable balance-of-payments positions, volatile and often speculative short-term capital flows and recurrent financial crises.

It remains to be seen what the current debate on reforming the international monetary and financial architecture will imply in terms of tightening multilateral rules similar to Bretton-Woods-type multilateral disciplines in monetary and financial matters. Macroeconomic policy co-ordination among those countries that have the greatest impact on international monetary and financial stability could achieve the same objective on a more voluntary basis. By aiming at maintaining real exchange-rate stability among the key currencies, it would help guide expectations that underlie international capital flows and hence reduce the likelihood of unsustainable interest-rate differentials and divergences of the exchange rate from underlying conditions (see, for example, Bergsten et al., 1999).

Should current efforts at reforming the international monetary and financial architecture remain inconclusive, strengthened South-South regional co-operation could prove to be a more feasible alternative for developing countries to reduce their exposure to adverse spillover effects, negative externalities from other countries' beggar-thy-neighbour policies, and speculative short-term interest-rate arbitrage (UNCTAD, 2007). Greater regional financial integration, for example through bond and loan issuance in regional currencies, could make intra-regional financial intermediation more effective and efficient, facilitate access to long-term financing, stabilise financial prices, and reduce balance-sheet currency mismatches, thus promoting regional financial stability. Swap agreements, reserve pooling and regional exchange-rate mechanisms, combined with greater macroeconomic and financial policy co-ordination, could secure stability and orderly adjustments of intra-regional exchange rates. And regional surveillance over macroeconomic and financial market conditions could provide early warning signals. The European experience holds useful lessons in this respect, but, given its geographic and time-bound specificities, it cannot be considered a blueprint for application by developing countries.

Since developing countries have gradually acquired greater weight in the global economic arena, they have a stronger need for a commensurate voice and representation in multilateral financial institutions. To strengthen the legitimacy of these institutions, key decisions need to be based on voluntary, full and equal participation, with an appropriate level of consensus. Achieving this will require a reassessment of the global economic governance structure, with a view to allowing developing countries to become proactive norm-setters.

5 Examples of changes in the effectiveness of policy instruments brought about by international forces

The impact of specific forms of international integration on the effectiveness of a chosen set of domestic policy instruments may be illustrated by referring to the Republic of Korea in the 1990s. According to Chang (2006), prior to the mid-1990s, monetary and financial policies there were run as an accessory to industrial policy. Through its control of the banking system, the government guided private investment to specific sectors. Reciprocal control mechanisms attempted to avoid moral hazard and excess capacity, while the government often acted as lender of last resort to smooth firms' liquidity problems. Tight capital controls were required to make this set-up function. In the early 1990s, when Korean firms started to enjoy creditworthiness in the international financial markets without government guarantees and the Republic of Korea applied for membership of the OECD, the government took a series of liberalisation measures that included, among other things, financial liberalisation and the granting of more managerial autonomy to banks. This allowed firms to accumulate substantial amounts of short-term foreign debt. Mounting international financial upheaval created severe liquidity problems for many firms that had high foreign-currency-denominated debt. The Korean currency depreciated sharply and firms indebted in foreign currency faced bankruptcy, as the dismantling of industrial policy had also abolished the policy instrument of the government acting as a lender of last resort.

It is widely acknowledged that the accumulation of sizeable foreign-exchange reserves with a view to building adequate self-insurance against a sudden stop and reversal of capital inflows is among the main policy responses to the Asian financial crisis. The interventions on foreign-exchange markets that create these reserves attempt to prevent or delay capital inflows from causing currency appreciation and undermining export performance.

However, avoiding an external payments deficit through prolonged reserve accumulation poses the risk of excessive domestic liquidity expansion with possible adverse implications for price stability and the efficiency of the financial system, thereby undermining the effectiveness of domestic macroeconomic policies. To keep liquidity expansion and inflation under control, many emerging-market governments have sterilised such interventions (see Mohanty and Turner, 2006, for country-specific examples).

China is among the countries that have chosen this strategy.[20] However, in order to prevent foreign-exchange interventions placing an excessive burden on sterilisation measures, China has also maintained controls on capital inflows. To further reduce net capital inflows, avoid excessive carrying costs of reserves, and minimise adverse effects on the effectiveness of monetary policy stemming from substantial sterilised foreign-exchange market intervention, China has partly liberalised private capital outflows. However, unlike accumulating reserves, adopting capital-account opening does not provide self-insurance against payments and currency instability and, as a counter-cyclical measure, may be difficult to abolish when conditions change. Taken together, this example illustrates that policy-makers can adopt a range of policy instruments to address certain targets, where the effectiveness of a specific instrument will be highly country- and time-specific.

6 Conclusion

This article has sought to examine how developing countries can effectively use their existing national policy space, and even enlarge it, without opting out of their international commitments. This examination leads to five main conclusions: (i) the tension between international integration and national policy flexibility is affected by several forces that pull in opposite directions; (ii) globalisation and the resulting rise in economic interdependence, across both countries and policy areas, as well as *de jure* restrictions to which developing countries have signed through supposedly sovereign decisions, have altered the degree of freedom for national policy-makers to design and implement effective national economic policies; (iii) whether international integration and regulation on balance increase or reduce the degrees of freedom in national policy-making depends on what type of policy instrument is affected, by how much and in

20. The following account draws on Yu (2009).

what direction; the balance is likely to differ across countries and types of integration; (iv) there remains considerable policy autonomy in macroeconomic and exchange-rate policies, particularly for the increasing number of developing countries with a strong external position – because of either substantial revenues from commodity exports or a deliberate accumulation of foreign-exchange reserves – and which are no longer (or never have been) subject to IFI or donor conditionality; and (v) effectively using existing policy space and enlarging it without opting out of international commitments requires action at both the national and international levels.

The measures outlined in this article result from an examination of constraints on developing countries' policy space and measures for its enlargement from a heterodox perspective of development policy-making. Accordingly, perspectives that give less importance to proactive macroeconomic and sectoral policies, such as World Bank (2005) or the Sachs and the Spence Reports, would argue that there is less need for moving away from the macroeconomic and exchange-rate policy assignments of the 1980s and 1990s, and that globalisation forces and international rules and commitments imply fewer constraints on effective policy-making than is argued by a heterodox perspective of development policy-making.

While all integrating countries face the trade-offs of international integration, country-specific calculations of the costs and benefits of a particular policy choice will differ, depending on at least three criteria: the country's strength in terms of both its international influence and economic situation, its exposure to an uncertain international environment, and policy sequencing:

- Lack of power internationally increases the benefits of *de jure* integration, because multilateral commitments will shield countries with little influence from the arbitrary coercive actions that internationally powerful countries can take, even though countries with little influence may find it difficult to shape international norms. A solid fiscal position and sustainable external accounts, low levels of sovereign and external debt, and little dependence on foreign capital will reduce the costs of *de facto* integration, because they will preserve much of the effectiveness of countercyclical and growth-enhancing macroeconomic policies.
- Greater uncertainty regarding the vulnerability to shocks reduces the benefits of both *de facto* and *de jure* integration. Developed countries currently deploy a host of subsidies in financial sectors (which are not prohibited by international agreements on trade in services, as these do not cover subsidies) and the automobile industry that affect the competitive position of firms in other countries (and may violate anti-subsidy rules). This has generated discussion among WTO members as to whether WTO rules are inappropriate in times of economic distress. This implies that integrating countries must carefully assess whether rules and regulations have sufficient safeguard clauses to deal with uncertainty and changing circumstances.
- A sequenced integration will increase the benefits of integration. At any level of economic development, a country's benefits from international integration differ across different spheres such as trade, investment, finance, labour and technology. For example, the existence of a functioning domestic financial

market and previous integration into international goods markets are significant factors in determining the impact of integrating a country's capital market on the effectiveness of its monetary and financial policies.

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