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Global Trade Union Program

Stabilizing an Unstable Global Economy by Promoting Workers' Rights

by
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Abstract

Financial crises in emerging economies have become more frequent. The poor are more likely than other groups to suffer a decline in their living standards from a financial crisis, making the stabilization of emerging economies a policy priority. Initially, researchers focused on identifying early warning signals for impending crises. However, such models failed to accurately predict crises. To stabilize emerging economies, policymakers thus reverted to active policy management. Essentially, policymakers can use macro economic policy measures, such as fiscal and monetary policy, or structural policies to stabilize their respective economies. Structural policies include, but are not limited to, better domestic financial institutions and improved workers' rights. As economies have eliminated restrictions on capital flows, policymakers have also curtailed their independence in setting monetary and fiscal policy. With macro economic policies less relevant, structural policies gained in importance. For example, policy makers could emphasize the development of domestic financial institutions. By developing such institutions, economies would reduce their dependence on external capital, and thus help to reduce the impact of one destabilizing factor. But domestic financial institutions, such as credit unions, cooperative banks, and public savings banks, will most likely require public support in order to serve a large retail market, due to the lack of economies of scale in serving many small accounts. Another structural policy would be the institution of workers' rights. By helping to improve workers' rights, policymakers would curb the potential for speculative financing. Better workers' rights are typically associated with faster productivity growth and a more equitable income distribution, helping to distribute a larger economic pie more equally. Because of this dual effect of workers' rights, real economic growth should be stronger and more durable, which in turn reduces the chance that financial sector growth outpaces real economic growth. If the financial sector and the real sector are less likely to diverge, the economy is by definition more stable. Recent empirical findings support the notion that better workers' rights are associated with more stable economies. There is one caveat, though. The improvement of workers' rights can be seriously hampered by increased capital mobility. Because capital becomes more mobile, firms can more easily threaten to relocate production in response to efforts to improve workers' rights. Hence, the potentially stabilizing effects of workers' rights are reduced in economies with fewer restrictions on capital mobility.

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Executive Summary

- Financial crises in emerging economies have become more frequent over the course of the past two decades. For instance, the IMF found that two-thirds of its member countries experienced serious banking sector problems between 1980 and 1996. Since the poor are more likely than other groups to suffer a decline in their living standards when financial crises turn into macro economic crises, a primary policy focus in global economics has been to find ways to stabilize emerging economies.

- Financial crises – banking and currency crises – have typically followed a certain pattern. Crises arise because expectations in the financial markets have outgrown what the real economy can deliver. A sign of a speculative financing that precipitates a crisis is a bubble in the stock market or the housing market, or a credit market boom that is not matched by a similar surge in productivity, output, and wage growth.

- Financial crises have become more frequent as economies have reduced their restrictions on capital inflows and outflows. Greater capital mobility typically leads to deregulation euphoria, fostering speculative financing, and it exacerbates booms and busts due to more rapid and larger capital movements into and out of an economy.

- In an initial reaction to the surge in financial crises, especially after the Mexican and the Asian financial crises in the mid-1990s, researchers focused on identifying early warning signals for impending crises. However, such models failed to accurately predict crises, due to data availability and due to the inability to accurately measure important variables, especially domestic institutional developments.

- To stabilize emerging economies, policymakers thus have to revert to active policy management. Essentially, policymakers can use macro economic policy measures, such as fiscal and monetary policy, or structural policies to stabilize their respective economies. Structural policies include, but are not limited to, better domestic financial institutions and improved workers' rights.

- As economies have liberalized their capital accounts, eliminating restrictions on capital inflows and outflows, policy makers have also relinquished their independence in setting monetary and fiscal policy. In fact, stabilizing macro economic measures often result in adverse capital movements, thereby reversing the beneficial effects of the initial macro economic policy decisions. For instance, expansionary fiscal policy could result in rising budget deficits, which in turn would indicate economic weaknesses to financial investors, who would withdraw their funds, thus prompting policy makers to raise interest rates to stem the tide of capital outflows, which in turn would slow down economic activity, furthering the crisis.

- With macro economic policies less relevant in an environment with reduced capital controls, structural policies gain in importance. For example, policy makers could emphasize the development of domestic financial institutions. By developing such institutions, economies would reduce their dependence on external capital flows, and thus help to reduce the impact of one stabilizing factor. But domestic financial institutions, such as credit unions, cooperative banks, and public savings banks, will most likely require some public support in order to serve a large retail market, due to the lack of economies of scale in serving many small accounts.

- Another structural policy would be the institution of workers' rights. By helping to improve workers' rights, policymakers would essentially curb the potential for speculative financing. Better workers' rights are typically associated with faster productivity growth and a more equitable income distribution. In other words, better workers' rights help to distribute a larger economic pie more equally. Because of this dual effect of workers' rights, real economic growth should be stronger and more durable, which in turn reduces the chance that financial sector growth outpaces real economic growth. But if the financial sector and the real sector are less likely to diverge, the economy is by definition more stable. Recent empirical findings support the notion that better workers' rights are associated with more stable economies.

- There is one caveat, though. The improvement of workers' rights can be seriously hampered by increased capital mobility. Because capital becomes more mobile, firms can more easily threaten to relocate production in response to efforts to improve workers' rights. Hence, the potentially stabilizing effects of workers' rights are reduced in economies with fewer restrictions on capital mobility.

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Introduction

Since the 1980s, financial crises in emerging economies, marked by rapid currency devaluations and massive numbers of failing banks, have become more frequent. For example, the IMF estimated that between 1980 and 1996, which was also a time of increasing openness to trade and capital flows, two thirds of its member countries experienced significant banking sector problems.

The costs of currency and banking crises are often staggering for the afflicted economies. Large financial crises often spill quickly over into the rest of the economy, so that the effects of the crisis are not only felt by savers and creditors, but throughout the economy. Currency crises, for instance, can result in rapidly rising prices as imports become quickly more expensive. At the same time, export revenues fall as export prices plummet, forcing export firms into bankruptcy and causing massive layoffs among those employed by export oriented firms. Similarly, because money is the conduit by which economic activity in an economy is coordinated, massive bank failures can easily interrupt the flow of economic activity. Creditors will have to repay loans earlier to help ailing banks meet their own obligations, and banks will be unable to extend credit for new projects, thus slowing investment and growth. Inflation, recession, and rising unemployment take their toll on many families in emerging economies that experience financial turmoil, pushing many of them into poverty. In the wake of the Argentine financial crisis in late 2001, for instance, the official poverty rate climbed above 50%.

The economic disruptions from financial crises are not limited to the crisis countries, but they can easily and quickly spill-over to trading partner countries. The Asian financial crisis, for example, was ultimately not contained in Asia, but it precipitated further financial troubles in Russia and Brazil. And a flood of cheap imports from the Asian crisis countries resulted in record trade deficits in the U.S., starting a recession in the American manufacturing sector that may have been one of the factors underlying the first U.S. recession in more than a decade.

In response to the rising frequency and the severity of financial crises in emerging countries, particularly in the wake of the Asian financial crisis in 1997, a number of attempts were made to stabilize emerging economies while keeping market based mechanisms intact. These efforts included the development of early warning signals.

However, the failure of researchers to develop conclusive early warning systems that will offer policy makers the tools to respond early enough to apparent weaknesses in their economies, the focus has shifted towards national policies that could help to stabilize emerging economies. Essentially policymakers face two choices, which are not mutually exclusive. They can either reinstate capital controls to slow the flow of money across international borders in an effort to regain some independence in policy making decisions. Or they can focus on so-called structural policies that would change local institutions. Among the structural policies that appear to hold

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some promise are the development of local financial institutions and the strengthening of workers' rights.

Because rapid capital movements in and out of a country are often underlying financial crises, policies that could slow these fluctuations could also help to reduce the chance of a crisis. Capital flows initially into a country because domestic financial institutions – banks, credit unions, savings banks and other lenders – do not provide enough of it. Put differently, if policies can be developed to build up domestic institutions, such as credit unions, postal savings institutions, or public savings banks, among others, more credit can be supplied domestically and the need for international capital inflows diminishes, and the chance of a crisis with it.

Another stabilizing institution that has gained some attention is the establishment of political freedoms, especially of enforceable workers' rights. The link between workers' rights and financial stability arises because better workers' rights help to establish a macro economic environment that is less conducive to speculative investments, which ultimately cause a crisis. Economic gains may become more equitably distributed, and economic growth may rise due to increased productivity, which can result from more resources allocated to education and skill development compared to a situation with fewer freedoms. As a result, domestic demand may be stronger, which means that investors have to rely less on financial speculation to generate good rates of return. With fewer speculative undertakings, the chance that borrowers will default in the future is lowered. And as banks face less of a chance that their borrowers will default on their loans, the chance of a crisis is also reduced.

There is one caveat, though. Greater openness of emerging economies to trade and capital flows has also given more bargaining power to firms. Researchers have noted that the rising mobility of capital and goods across international borders has hampered efforts to establish enforceable workers' rights in emerging economies and that that has lowered the bite of enforceable workers' rights in emerging economies. If a firm is unhappy with the workers' rights in one country, it has more opportunities than ever before to relocate production elsewhere. As a result the effectiveness of workers' rights in mitigating financial instabilities is severely reduced in more open economies.

Financial and Economic Crises

Before considering the causes and possible remedies it seems useful to delineate some definitions first. Financial sector crises typically come in two forms, banking crises or currency crises. Although there is no fast and hard rule what constitutes a banking crisis, most researchers consider "bank runs or other substantial portfolio shifts, collapses of financial firms, or massive government intervention" as crisis (Lindgren et al., 1996:20). Noticeable problems short of a crisis are considered significant banking problems, but this often proves too broad a measure to be useful for economic analysis.

In comparison, currency crises, or balance-of-payment crises showing the main underlying cause of the crisis, are reflected by a rapid devaluation of the currency. However, a country may be able to fend off a speculative attack on its currency by selling its reserves or by raising interest rates (Eichengreen et al., 1995). Typically researchers have used an index created out of changes in the

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exchange rate, official reserves and interest rates to measure speculative attacks or currency crisis. If the index increases more than a pre-set amount, generally two standard deviations, it is considered a crisis (Eichengreen et al., 1995). Due to measurement problems, researchers have moved towards creating this index, though, by only including exchange rates and official reserves (Kaminsky and Reinhart, 1999).

Often banking and currency crises are highly correlated, with one leading the way for the other. Moreover, financial sector problems tend to spill-over into the real sector, most directly through credit crunches or imported inflation, thereby depressing domestic economic activity. But there is no consensus on what constitutes a macro economic crisis in the empirical literature. Some have used rescheduling of external debt, arrears on external payments or inflation rates in excess of 100% as macro economic crises (Sachs and Warner, 1995), others defined periods of low or negative growth as macro economic crises (Lustig, 2000), and again others have used extraordinary fluctuations of growth rates to reflect a macro economic crisis (Bannister and Thugge, 2001). Since macro economic crises, regardless of how they are defined, tend to follow currency or banking crises, the rest of this chapter focuses on the causes of and remedies for these crises.

The Causes Underlying Banking and Currency Crises

The standard approach to financial market development proposed by the international financial institutions, such as World Bank or IMF, is financial liberalization. The underlying theoretical argument is that financial market deregulation improves an economy's efficiency. More international capital mobility and less domestic regulation should enhance the real economic performance of an economy. In contrast, though, some economists have argued that especially external liberalisation increases competitive pressures on domestic banks, and induces them to accept greater portfolio risks than they would in absence of international competition (Demirgüç-Kunt and Detragiache, 1998). Similarly, some sceptics of financial liberalization have argued that greater inside and outside liberalization increases the chance for financial crises as it entices investors to direct funds into speculative projects often driven by "deregulation euphoria" (Grabel 1993; Arestis and Demetriades, 1999; Weller,2001).

Financial liberalization is generally understood as the deregulation of external capital flows and of domestic financial markets. External liberalisation includes the reduction or elimination of controls on capital flows into and out of a country, which raises the possibility for more short-term capital flows and more foreign direct investment (FDI) into and out of an economy. In comparison, the liberalization of domestic financial markets include the elimination of credit ceilings, lending requirements, and entry restrictions, and the widening of the operational scope of financial market participants. For instance, banks may be allowed to sell insurance, and investment bankers may be allowed to provide commercial loans (Litan et al., 2001).

The liberalization of financial markets is usually proposed in response to an actual or perceived lack of financial capital. The goal is to eliminate financial constraints for businesses, so that they have more funds available for investments in plant and equipment. Banks are also expected to become more efficient increases following deregulation, which should make more credit available for investments. For one, banks should find it easier to attract deposits after the

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elimination of interest rate ceilings since they can now pay any interest rate necessary to attract the deposits they need to extend the loans they see prudent to make. Moreover, banks will be able to borrow money overseas once controls on capital inflows have been lifted. Because this money will be borrowed under the loan standards of international banks, domestic banks will also have to implement good practices, such as sufficient equity, to qualify for these loans. This should make them more efficient in their operations. On the other hand, banks should also be more inclined to lend without interest rate restrictions since they can now charge the interest rates necessary to turn a profit on their operations. In addition, domestic competition increases because more banks can enter domestic financial markets, thus forcing other banks to become more active in their lending business. Because the liberalization of financial markets is founded on the idea that markets always know best, it is assumed that banks know how much to lend and who to lend to. In other words, money is expected to go towards their most efficient uses, thus boosting investment, productivity and growth.

The theory of financial liberalisation, though, misses important dimensions of the way the world works. For instance, it has been recognised that the level of capital a bank has can influence its lending behavior and its stability (Stiglitz, 1994). Banks with low capital and lower than expected earnings may seek out high risk, high return projects, thereby becoming unstable. A widely noticed example was the U.S. savings and loan (S&L) crisis in the late 1980s, when poorly capitalised banks undertook high risk real estate ventures. In emerging economies, greater financial market competition, particularly from well-capitalised foreign banks may set this process in motion by lowering the profitability of domestic banks. In fact, "an increase in the share of foreign banks leads to a lower profitability of domestic banks" (Claessens et al. 1998). Poorer profit expectations may even lower a bank's franchise value as to leave it *de facto* bankrupt. Such banks stand to lose little or nothing from taking on greater risks and by engaging in speculative investments, mainly in the stock or the real estate market.

More intensive competition is not the only factor that causes greater instability after liberalization. Financial firms may also find more investment opportunities, and they may find themselves driven to more speculative investments either through more intensive competition or in an atmosphere of "deregulation euphoria" (Arestis and Demetriades, 1999).

A crucial problem arises because opportunities to engage in more speculative financing are likely to increase after financial liberalization because of financial deregulation, which follows a period of real improvements, but which also gives rise to speculative bubbles. In particular, based on Minsky's (1986) "financial instability hypothesis", some economists have argued that greater liberalization is likely to result in more speculative investments, and in more high risk, high return investments, with destabilising consequences for the entire economy (Grabel, 1993; Weller, 2001).

In this view, financial deregulation leads to short-term economic gains, and hence fuels optimistic expectations. After financial deregulation, liquidity improves and more funds are available for productive and speculative purposes. The increase in investment opportunities is generally matched by a decline in financial market regulations. An expanding real sector flush with capital, booming asset markets, increasing rates of return point towards an improving economy. With higher real interest rates and with expanding real and financial sectors, more funds are then at-

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tracted from overseas. More capital inflows, lead to a real currency appreciation, hence attracting even more capital.

Unfortunately, changes in economic fundamentals after liberalization merely improve the economic situation in the short-run. A continued currency appreciation helps to attract capital, which follows the promise of short-term gains in deregulated financial markets. Both a continued overvaluation and the diversion of funds for speculative purposes, particularly in stock or the real estate markets, generate the illusion of a sound and improving economy. Thus, otherwise well-capitalised, and sound banks are tempted to extend credit beyond prudent limits. While the real sector is hurt by a currency appreciation, by deteriorating terms of trade, and by the lack of credit (since it is going to other – more speculative – uses), financial markets still expand liquidity for speculative purposes in asset markets. The stock market and the real estate market are doing well, while simultaneously real production slows.

More financial speculation raises the chance of financial crises because banks face a larger downside risk. In particular, as the real sector slows down, debt-to-equity ratios are likely to rise, and the chance of bankruptcy increases. Similarly, asset market speculation means that at some point speculators' optimistic profitability expectations are not met, and they are unable to meet their own financial obligations. With rising defaults, international investors become more likely to withdraw their short-term funds, further weakening the economy. Rapid capital outflows translate into a lack of funds for ongoing projects, thus fuelling an economic downturn in all sectors of the economy. Capital outflows reverse the currency appreciation, thereby adding to the burden of those who owe loans denominated in foreign currency. With further increasing loan defaults, a downward spiral is set in motion that depresses financial and non-financial sectors alike.

It is important to understand that firms are in a precarious situation before a crisis occurs due to the emphasis on short-term returns that makes long-term financing harder to obtain. If investors can gain significant returns on speculative ventures in a short period, less funds will be allocated to more long-term productive investments, where investors have to be patient. Thus, firms will generally find it harder to secure long-term external financing after deregulation. Since especially smaller firms depend on external financing, the allocation of funds away from productive uses is likely to hurt small and medium-sized enterprises (SMEs) or start-ups more than large corporations. Consequently, productive investments may not be undertaken, and firms can lose their competitive advantages, thereby possibly increasing the default risk for banks, and fuelling the flames that ultimately lead to the firestorm of economic crises.

Adding to the vicious cycle is the fact that the government is caught in an unenviable situation. To avoid a financial crisis, governments often revert, at least temporarily, to raising interest rates to keep short-term capital from leaving. Thus, monetary authorities add to the growing burden for borrowers, raising in turn the risk that borrowers will not be able to repay their loans. Similarly, once a crisis is set in motion governments face increased demands on their budgets that have already been strained because of a slowdown in the real sector.

The empirical evidence on the connection between financial liberalization and financial crises has been mounting. In a survey of banking sector problems the IMF found that two-thirds of its

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member countries have experienced banking sector problems between 1980 and 1996 i.e., the period when financial deregulation found widespread acceptance (Lindgren et al., 1996). Similarly, in a summary of recent studies on capital mobility, Blecker (1999) found that at least for emerging economies there is strong evidence that increased capital mobility raises the chance of crises. Further, Kaminsky and Reinhart (1999) found that financial liberalization often preceded a banking crisis. Similarly, Grabel (1998) showed that increased financial fragility was a systematic occurrence after financial liberalization for emerging economies following the Asian crisis. In an econometric study of 26 emerging economies, Weller (2001) found that countries are much more likely to experience banking and currency crises after financial liberalization than before because their economic structure has become more susceptible to financial market risks. Lastly, the IMF devoted part of its September 2002 World Economic Outlook (IMF, 2002) to the issue of global integration and increased volatility, while accepting the premise that trade integration resulted in more macro economic volatility and financial integration to more volatile capital flows.

Even though financial liberalization may offer some advantages, most of them are short-lived in emerging economies that have not developed the domestic institutions to control swings in capital flows. For instance, liquidity constraints are likely to be reduced after liberalization. But since a non-trivial share of additional funds may find its way into speculative financing, not all businesses may benefit equally from the additional liquidity. Similarly, liberalization offers more access to new economies for multinational businesses. However, if a crisis occurs, demand in these economies may be depressed for lengthy periods. And the liberalized environment may offer some growth opportunities, but in a more volatile environment as exchange rates, credit supply, and interest rates are prone to fluctuate more after liberalization than before. Thus, if some form of liberalization is needed to arrive at more efficient financial systems, it has to be done under avoidance of the drawbacks.

Global Poverty and Financial Crises

Although financial crises are debated at the aggregate level, they have real implications for people living in crisis afflicted countries. The increased frequency of financial crises has contributed to the lack of success in fighting poverty in emerging economies because financial crises can quickly spillover into the rest of the economy. This will result in loss of employment, wages, and social services, which in turn will disproportionately hurt the poor, who have little defense mechanisms against the vagaries of the macro economy.

The evidence on international poverty suggests that poverty reduction has not been particularly widespread.

Researchers closely associated with the World Bank have attempted to measure changes in international poverty with disheartening results. Chen and Ravallion (2001) invoke an international poverty line of $1.08 per day in 1993 dollars based on purchasing power parity (PPP) exchange rates. At this threshold, poverty at the global aggregate level is unequivocally increasing in absolute terms: from 1,196.48 million in 1987 to 1,214.18 million in 1998 (World Bank, 2001).

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Chen and Ravallion (2001) do however report some geographically isolated reductions in relative poverty, though in many places the rates remain very high. In 1998, the share of the population living in poverty in industrializing countries was 32%, down from 36% in 1987. Between 1987 and 1998, the share of the population living in poverty remained constant in Sub-Saharan Africa, rose slowly throughout Latin America, and more than tripled in Eastern Europe and Central Asia. In the same time in South Asia, the poverty rate fell from 45% to 40%, and in East Asia it fell from 27% to 15%.

However, absolute poverty lines, such as the $1.08 per day threshold, ignore country-by-country differences in the incidence of poverty. By using an absolute poverty line, the share of people living in poverty may be understated. Using national poverty lines instead of the international poverty line, on average an additional 14% of the population would be considered poor (World Bank, 2001). An alternative to both the national and international poverty line methods is to use a relative poverty line based on mean consumption or mean income levels in each country. Using such a relative poverty line instead of the international poverty line shows, on average, an additional 8% of the population to be considered poor (Chen and Ravallion, 2001).

Moreover, Wade (2001) and Pogge and Reddy (2002) questioned the use of an international poverty line on conceptual grounds. Chen and Ravallion (2001) use PPP rates from 1993 to establish individual national poverty lines and then adjust these by national consumer price indices (CPIs). Both the CPIs and the PPP exchange rates are constructed on a basket of all goods and services, many of which are not likely to be consumed by people living at or near the poverty threshold. Pogge and Reddy (2002) argued that this biases the absolute poverty line down. A more desirable methodology would employ price indices and PPP rates based only on basic goods and services, which they estimate could potentially raise poverty by as much as 30-40% (Pogge and Reddy, 2002).

Last, the poverty estimates fail to capture the full impact of recent financial crises, which makes it very likely that future revisions will show still less progress in poverty reduction. Lustig (2000), for instance, argued that frequent macroeconomic crises are the single most important cause of rapid increases in poverty in Latin America. Consequently, future revisions to the poverty trends based on the absolute poverty line in the late 1990s could show smaller reductions or even increases in the crisis stricken areas. Revisions to past data already show less success in poverty reduction than previously assumed. Chen and Ravallion (2001) show that the reduction of people living below the poverty line between 1987 and 1993 was not 4 percentage points, as estimated in 1997 (Ravallion and Chen, 1997), but less than one percentage point.

The evidence on global poverty shows that, using an absolute poverty measure, progress in poverty reduction was small. Moreover, methodologically more appropriate poverty measures suggest that the incidence of poverty was actually higher. And the exclusion of relevant data for crisis stricken countries in the most recent data suggests that the trend towards poverty reduction was probably overstated. Thus, global poverty reduction remains elusive, notwithstanding isolated successes in some countries.

The fact that incidences of poverty reduction has been elusive and, at best, geographically isolated has given rise to a small debate among economists. In a series of influential papers, re-

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searchers from the World Bank concluded that trade was good for the poor and that failure to reduce poverty could be attributed to the failure of countries to liberalize trade and capital flows (Dollar and Collier, 2001; Dollar and Kraay, 2001a, 2001b).

However, the argument that more liberalization would help to reduce poverty suffered from a serious flaw as Weller and Hersh (2003) pointed out. The research attempting to show that more liberalization, which has also been associated with increased financial instabilities, is good for the poor conflated the concepts of trade flows with trade liberalization. In particular, it was often assumed that more liberalization, i.e. fewer hurdles to exports and imports, would automatically translate into more flows of goods across international borders (Sachs and Warner, 1995; Dollar and Kraay, 2001a, 2001b). But the two are not necessarily the same. One, trade liberalization, measures the conditions under which trade conducted, and the other, trade flows, measures how much a country actually trades. Just because a country makes it possible for more goods to flow doesn't mean that they will flow, as is also the case with capital flow liberalization (Eichengreen, 2001).

The distinction between policy regime and economic outcomes is crucial when it comes to the incomes of the poor. Weller and Hersh (2003) studied the effects of both policy regimes and economic outcomes on the incomes of the poor simultaneously. In their research, they found specifically that increased macro economic volatility as a result of more capital mobility has a consistent negative effect on the incomes of the poor. That is, although the poor are typically not financial wealth holders, who could lose a lot of money immediately in a financial crisis, they are ultimately the largest victims of a financial crisis, when it spills over into the rest of the economy.

The accumulated evidence suggests that the discussion over the causes of financial crises and how to avoid them is not just an academic exercise, but that it has urgent real life implications. As the world economy has become increasingly more integrated, financial and economic crises have become the bane of many emerging economies. Often financial and economic crises take a disproportionate toll on the poor, who have little defense mechanisms, such as wealth, capital flight or emigration. Hence, it should not be surprising that improvements in the lot of the poor have been hard to see in a more and more open world economy.

Relying on the Market: The Effectiveness of Early Warning Systems

Instead of pondering alternatives to liberalization, policymakers could consider institutional improvements that would allow for early detection of a looming crisis. If an effective early warning system could be developed, policies could be adjusted as needed to heed off the crisis.

A number of empirical studies on financial crises have set out to identify predictors of crises. In a seminal paper on currency crises, Eichengreen et al. (1995) found that currency crises across a sample of twenty OECD countries over the period from 1959 to 1993 exhibited strong regularities. In particular, they found that changes of monetary aggregates, budget deficits, foreign exchange reserves, exports, balance of payments deficits and inflation had significant statistical predictive powers. Kaminsky et al. (1998) and Kaminsky and Reinhart (1999) applied a similar approach to five industrialized and fifteen developing countries for the period between 1970 and 1995. Both studies found that exports, the real exchange rate, the ratio of money supply

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to official reserves, and price indices were statistically significant in predicting currency crises. Further, Corsetti et al. (1998) and Kaminsky and Reinhart (1999) found that banking crises often preceded currency crises. Corsetti et al. (1998) proxied the stability of the banking sector by the bad loan ratio, whereas Kaminsky and Reinhart (1999) relied on similar macro economic indicators for banking crises as for currency crises. Finally, Eichengreen et al. (1995) found evidence of contagion effects as the likelihood of a currency crisis occurring increased when a crisis has occurred elsewhere.

But how valuable are the empirical studies in predicting crises? Berg and Patillo (1998) analyzed three studies, Kaminsky et al. (1998), Frankel and Rose (1996), and Sachs et al. (1996), to assess their potential predictive power using the example of the Asian currency crisis. Frankel and Rose (1996) based their study on annual data from the IMF for more than 100 developing countries, which had the shortcomings that their crisis indicator cannot account for speculative attacks and that annual data are likely to miss short-term developments. Sachs et al. (1996) studied macro economic variables in 20 countries during the Mexican peso crisis. Since it was only based on one crisis and its global fall-out, albeit in a very detailed fashion, it may not be a suitable basis for predictions of crises in other countries. Kaminsky et al. (1998) set out to find early warning signals for currency crises. Their research reviewed 25 earlier studies on currency crises and identified statistically significant indicators for crises. Consequently, they selected fifteen indicators (out of a possible 103) based on theoretical considerations and data availability. These indicators were then used to find empirical regularities among twenty countries over the period from 1970 to 1995. Berg and Patillo (1998) found only the Kaminsky et al. (1998) approach to yield reasonable prediction results. However, in each case there remained a large possibility of missing a looming crisis.

There are two reasons why early warning signals are hard to find. First, empirical studies regarding financial crises appear to have limited success because adequate and timely data are often not available, which is especially apparent in the studies on banking crises. Second, even if empirical research were successful in finding adequate indicators for looming crises, it is not clear whether policymakers could use this information to avoid a crisis. Early warning signals may simply inform policymakers of the unavoidable. If policymakers decide to use a particular early warning model, all market participants are likely to be aware of that. Hence, market participants are likely to act on the information of early warning models provide, thereby leading to “self-fulfilling prophecies”.

Stabilizing Emerging Economies through Local Institutions

Because market based solutions to the increased financial instabilities that emerging markets are facing are unlikely, alternative, less market oriented solutions seem appropriate. Without finding ways to stabilize emerging economies, the primary goal of development economics – poverty reduction – will remain an elusive one.

Instead of focusing on developing early warning systems for financial and economic crises, researchers have begun to concentrate on identifying potentially stabilizing institutions. These institutions may include developing local financial institutions, capital controls, or enforceable workers’ rights.

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National policy makers have essentially three tools at their disposal to stabilize emerging financial markets after their opening. They can use fiscal policy, monetary policy, and structural policies. Fiscal policies encompass spending and tax initiatives, monetary policy refers to the use of interest rates to regulate the amount of money, and structural policies describe institutional changes, such as regulation or deregulation of labor markets or product markets, e.g. for finance or energy.

In an open economy, where money can freely flow in and out, fiscal and monetary policy choices by an individual country are typically constraint, which makes it particularly hard to use these tools to stabilize an economy. For instance, prior to an economic crisis, economic activity typically slows down as exports are hampered by a high value of the domestic currency as financial capital is flowing into speculative activities instead of productive ones. Theoretically the government could be tempted to use the fiscal policy tools at its disposal – spending increases or tax cuts – to stimulate real economic activity. However, because the economy is already slowing down, governments typically already incur deficits. Using active fiscal policy would thus increase these deficits. Although this is expected of counter-cyclical fiscal policy that expands government activities in an economic slump, rising deficits are usually perceived unfavorably by international financial investors, which will start withdrawing their funds. Similarly, policy makers could use monetary policy to stimulate the economy by lowering interest rates. But lower interest rates mean lower earnings for international investors, who will start withdrawing their funds. Hence, the crisis becomes a self-fulfilling expectation. Policymakers intervene because they expect a crisis, and because they intervene, financial investors jump start the crisis by withdrawing their money.

To avoid the dilemma of a self-fulfilling crisis in an open economy, countries could institute capital controls, which would make it harder for international investors to withdraw their funds, and thus provide domestic policymakers some leeway in designing their own fiscal and monetary policy. Alternatively, countries may decide that they do not want to restrict the free flow of capital, either to finance trade deficits or domestic investments or both, and thus focus on structural policies to stabilize their economies. Two examples of such structural policies are improved domestic financial institutions and better workers' rights.

The Role of Capital Controls in Stabilizing Emerging Economies

A country's ability to develop financial institutions and use public policies to stabilize its financial markets is limited by a lack of capital controls and by its participation in international agreements. For instance, in 1999, some aspects of the design of Germany's savings banking system were challenged under EU rules, pitting an international agreement against national development interests. Similar conflicts may arise under GATS. Also, government subsidies tend to be evaluated negatively by international capital markets. If a government wants to continue subsidizing local financial institutions, and if controls on external capital flows have been reduced, a country's sovereign bond ratings may be lower than otherwise, resulting in higher interest rates, less investment and slower growth.

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Financial market development hence becomes a balancing act between developing local financial institutions and the need to attract foreign capital. The public policy issue is then to determine which capital flows are desirable and which ones are not. The distinction between portfolio investment and foreign direct investment (FDI) is typically of considerable importance to such an analysis.

Portfolio investment provides capital to the bond and stock markets from abroad. Whether portfolio investment increases the availability of new capital to firms depends on a number of factors. If, for example, foreign investors merely buy existing shares on the stock market, firms will not necessarily receive more funds. Further, if foreign investors purchase bonds there is no mechanism that prohibits firms from using these funds for speculation. Short-term capital flows, or "hot money" are often found at the core of financial market volatility. Hence, policy makers need to possess the tools to slow down the flow of portfolio investment and to encourage more long-term capital flows.

It is recognized, especially in light of the Asian financial crisis, that a country - should have the right to control capital flows if they become a danger to its economic stability. The unilateral imposition of strict capital controls by Malaysia in the fall of 1998 has served as a case study for the use of capital controls during currency crises (Ariyoshi et al. 2000).

Countries can impose a variety of capital controls. For one, countries can impose minimum stay requirements. International investors would be prohibited from withdrawing their funds prior to a pre-set time limit; capital could only be withdrawn gradually, thereby helping to avoid a financial panic. Another approach are so-called "Tobin taxes", or international capital transactions taxes, which would levy a penalty on short-term capital withdrawal, while impacting longer term capital to a lesser degree. Chile's unremunerated reserve requirement (URR) that was in effect between June 1991 and September 1998 constituted an "asymmetric Tobin tax" that was levied only on capital inflows. The URR was designed to make international loans with maturities of less than 90 days more expensive than loans with a greater maturity. Third, countries could also impose outright prohibitions of certain types of capital movements. Countries could require that profits earned on FDI are reinvested in the host economy.

Evaluations of the effectiveness of capital controls are rare. In a collection of fourteen country studies, Ariyoshi et al. (2000) provided a preliminary evaluation of the effectiveness of capital controls in terms of stabilizing emerging economies. They found that capital controls cannot substitute for sound macroeconomic policies; that no single measure can always be effective everywhere; that targeted controls leave sufficient room to be circumvented, and hence are likely to be less effective than comprehensive controls; and that the choice of controls is determined by the administrative capacity of a country.

However, the research did not consider the potential trade-off between greater stability and slower growth following the lack of capital. Klein and Olivei (1999) found, based on IMF data, that developed countries with open capital accounts were also more likely to grow faster from 1986 to 1995 than countries with closed capital accounts. Although their results did not find a link for developing economies, these findings may be subject to revisions as more and better data become available. In particular, Edison et al. (2002) concluded, based on a sample of 57

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countries, that greater financial integration, which includes fewer capital controls, may be associated with faster growth.

Besides controlling short-term capital, policymakers have also focused on attracting FDI. Some FDI includes the physical relocation of technology. But how much of this technology will benefit the host economy depends on national regulations. Wholly owned subsidiaries, for instance, are likely to guard their technological advantages very closely so as not to nurture competitors. In the case of joint ventures between foreign and local partners, such proprietary control is less likely. Public policies can encourage technology transfers, for example by requiring that foreign investors partner with local businesses by setting limits on the share of a local business that foreign residents can own. Similarly, host economies can prohibit foreigners from owning real estate.

Although there are clear economic advantages to implementing or maintaining capital controls in emerging economies, they are often not a viable policy option. For one, countries are often in need for additional financial capital to finance investment. However, once rules for capital inflows are loosened, it is difficult to reinstate controls on some form of capital flows and not on others. Financial investors may find ways to circumvent existing rules. Also, some capital controls are meant to slow down the flow of capital, not to eliminate it all together, such as Tobin taxes. However, the expected rates of return from short-term investments in liberalized emerging economies are often a multitude larger than the speculation taxes imposed on short-term capital flows. Hence, many economists doubt that such taxes will have any noticeable effect[1].

The alternative to implementing capital controls thus may be to reorganize the structure of emerging economies to make them more stable. To examples of such a reorganization are the development of local financial institutions and the development of enforceable workers' rights.

Stabilizing Emerging Economies through Local Financial Institutions

One possible alternative, or addition, to financial liberalization is the development of domestic financial systems. Such domestic developments could be substitutes for or complements to capital account liberalization. However, two issues need to be addressed. First, financial institutions should receive priority over capital markets. Second, stable financial markets require public support, either in the form of prudent supervision and regulation or in the form of government subsidies.

Capital markets can provide some funds for investments, but their most important role appears to be the transfer of ownership. The U.S. equity market, for instance, has not been a net source of funds, but a net drain on funds as net equity issues in the corporate sector were negative in every quarter except one between 1994 and 2001. Obviously, smaller companies and start-ups have no or little access to capital markets and hence have to rely on financial intermediaries, such as banks, even more so than larger, more well-established firms. Thus, most companies need to rely on banks and other external finance providers, such as venture capitalists, to a larger degree than

[1] Some economists still support capital controls for other reasons. For instance, due to the size of international financial markets Tobin taxes may help to generate large amounts of revenue, even if they have little effect on the overall movement of international capital flows.

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on capital markets as a source of external funds for investment. The example of the advanced economies suggests that in developing economies, the development of local finance providers needs to take priority over the development of deep and broad capital markets (UN, 1999).

Developing stable local financial institutions, though, depends on public support. Particularly when financial markets are deregulated, regulatory and supervisory institutions need to be strengthened because of the greater chance of destabilizing, or even fraudulent activities. Further, the development of local institutions, such as credit unions, co-operative banks, savings banks, or postal savings unions, can provide more funds without increasing financial fragility. Postal savings unions, for instance, played an important role in Japanese development by channeling the funds from large numbers of small deposits to large-scale development projects. These institutions, which can be restricted from engaging in speculative activities, can be used to stabilize the economy. However, because these institutions tend to serve a large number of small clients, their operations are often costly. To be able to compete, especially if interest rates are deregulated, the higher costs that these institutions face from servicing a large number of relatively small clients require public subsidies. Subsidies can come in the form of office space for postal savings unions, or in the form of tax credits. Credit unions in the US, for instance, enjoy a tax-free status. Also, German savings banks are government guaranteed, which allows them to offer credit at below market rates.

Stabilizing Emerging Economies through Better Workers' Rights

Another local institution that could help to promote financial and economic stability are enforceable workers' rights. It is important to keep in mind that workers' rights are conceptually, and often also practically different from labor standards. While labor standards refer to a codified, normative institution, they may differ from the actual rights that workers enjoy in practice due to a lack of enforcement. In other words, labor standards refer to the rights that should be afforded to workers, whereas workers' rights encompass the rights that workers actually get to enjoy.

International labor standards are based on a number of conventions adopted by the International Labor Organization (ILO) over the past seven decades (Sengenberger, 2002). The International Labor Organization's (ILO) Core Labor Standards include the prohibition of forced labor, nondiscrimination in employment, freedom of association, freedom of collective bargaining, and prohibition of child labor. Despite the fact that many countries have adopted ILO conventions pertaining to labor standards, many workers often do not enjoy the full rights that are supposed to be afforded to them (Heintz, 2002; Sengenberger, 2002).

Workers' rights reduce the chance of financial crises because they create a macro economic environment that is less conducive to speculative investments. Better workers' rights result in higher productivity growth, thus leading to faster economic growth. Improved workers' rights also tend to result in a better distribution of income, both among workers and between workers and firms. In other words, better workers' rights lead to larger overall output that gets more evenly distributed. As the benefits of faster growth are more evenly distributed, local demand is stronger and more stable. Because the liberalized pre-crisis environment is typically characterized by more credit and more investments, stronger demand as a result of better workers' rights means

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that supply and growth increase in tandem, rather than supply outpacing demand. Because businesses are more likely to sell the bulk of the products they are supplying, they are less likely to default on their loans, and hence the chance of a crisis is diminished.

Workers' Rights and Economic Growth

The bulk of the economic research on workers' rights shows that these workers' rights are associated with significant increases in economic growth in the nations that have implemented and enforced them. In particular, child labor, forced labor, labor market discrimination, and legislation barring unionization or collective bargaining all inhibit productivity growth.

In theory, child labor and forced labor increase the supply of cheap or free labor within a country, driving down wages for everybody. Easy access to cheap labor removes incentive for firms to lower their costs by developing or adopting new technologies. Consequently, productivity growth is slowed. Furthermore, the fact that children are working in low-wage jobs instead of attending school will impede the growth of a nation's stock of human capital in the future, potentially inhibiting long-term productivity growth as well (Maskus 1997).

Economic theory also suggests that labor market discrimination may impede effective matching in the labor market between employers and workers. Economies are much more productive when jobs are allocated on the basis of skills and ability instead of ethnicity, gender, or caste (Acemoglu and Shimer 1999).

From a theoretical perspective, the right to form labor unions and bargain collectively has the greatest potential impact on economic growth. Unions give workers a direct voice to management, making it more likely that conflicts will be resolved through discussion rather than through employee separations (i.e., firing or quits). Unionization reduces turnover, making it more likely that employees will develop valuable job-specific skills and more likely that employers will invest in long-term training, both of which contribute to productivity growth.

The evidence shows that these growth-enhancing effects of workers' rights are strong. Palley (2000) showed that, in the case of 15 developing countries, the adoption of CLS was positively related to higher rates of economic growth. Buchele and Christensen (2003, 2001, 2000) found that workers' rights within the Organization for Economic Cooperation and Development (OECD) were positively associated with economic performance. A recent World Bank report (Aidt and Tzannatos 2003) showed that most studies on the issue find that coordinated collective bargaining was associated with improved macroeconomic performance in the 1970s and 1980s (evidence for the 1990s was mixed).

Table 1 (see appendix) provides some evidence on a sample of 17 nations that the OECD has identified as adopting labor standards over the past 20 years. On average, economic growth and growth in manufacturing has risen in nations after adopting CLS. Export growth has fallen, but this is, contrary to conventional wisdom, not necessarily a sign of weakness. Rather, it may signal the healthy re-orientation of these economies toward emphasizing domestic demand over exports, as is discussed further below in more detail.

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Labor standards and income distribution

The evidence on the effect of workers' rights on income distribution is even more powerful than their effects on growth. Besides making the economic pie larger, adopting labor standards also increases how equally the pieces of this pie are cut.

Workers' rights give a voice to more people both on the company level as well as on the national level, providing a check to the narrow interests of economic elites. Thus, workers' rights have a direct effect on how economic resources on the company level are distributed, and they have an indirect impact on the economy-wide distribution of national income. In either case, better workers' rights should lead to a more equitable distribution of income.

The empirical evidence supports this view. Rodrik (1998) showed in a study of over 100 nations that countries with more political freedoms pay wages that are 10-20% higher than in less free countries. For instance, a country like Mexico could realize average wage gains of 10-40% were it to attain a level of political freedom similar to that found in the United States. In comparison to other policies recommended by the IMF, studies sympathetic to trade liberalization found that complete removal of all trade barriers in the world will provide Mexico an average wage increase of less than 2% (Brown, Deardorff, and Stern 2001). Palley (2000) showed that adoption of CLS is associated with a significantly more equal distribution of income. And Aidt and Tzannatos (2003) stressed that union density and bargaining are positively correlated with more equal earnings distributions. Additionally, Alesina and Rodrik (1994) pointed out that more equal income distribution is, in and of itself, correlated strongly with improved economic performance. Workers' rights, then, help spark a virtuous circle of equality and economic growth. Buchele and Christiansen (2003) found a similarly striking correlation between an index of workers' rights and income equality in a sample of OECD nations.

The vertical axis in figure 1 (see appendix) shows the ratio of earnings of the top 10% of earners to the earnings of the people with the lowest 10% of earnings. The horizontal axis shows an index of workers' rights constructed by Buchele and Christiansen (2003), which is based on information about the strength of employment protection laws, the scope of union density and collective bargaining agreements, and income security and social protection. Enhanced workers' rights are strongly correlated with more equal incomes, as the correlation coefficient of –0.87 (out of a possible –1) suggests.

Labor standards, crisis avoidance, and recovery

Given the first round of crises in Latin America in the early 1980s, the Asian crisis of 1997-98, and Argentina's present financial-market-induced depression, it is now generally accepted that financial crisis avoidance and recovery are some of the most important tasks facing policymakers in developing nations.

Research has shown that the poor are particularly vulnerable to the effects of financial crises. Lustig (2002) asserts that "crises not only result in higher poverty rates, but also may cause irreversible damage to the human capital of the poor....The poor are particularly vulnerable to negative shocks for a variety of reasons." A recent World Bank report (1999) reinforces this

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finding that economic insecurity (unemployment and variability of employment and wages) ranks high among the concerns of the poor. A range of macroeconomic and financial policies can help developing nations avert crises (Blecker 1999). One important recommendation is for countries to emphasize strengthening policies that could boost domestic demand (Blecker, 1999; Palley, 2000, 2001). Nations that pursue policies that would enhance domestic demand are less subject to external shocks. Furthermore, firms are less likely to build up too much capacity if domestic demand is stronger. Problems of overcapacity, often driven by "easy money" fuelled by capital inflows, is usually at the core of financial crises. Investors eventually decide that their profit expectations cannot be realized, leading to capital withdrawal and bankruptcies.

A key ingredient to strengthen domestic demand is strong growth that is equitably distributed. Wage earners, especially at the low end of the wage scale, spend more of their incomes than affluent owners of capital, a trend that is obviously accentuated when overall economic growth is strong. Equitable distribution of growth provides a stable, robust component to domestic demand, allowing domestic producers to make long-term plans and produce sufficient output to expand and make productivity-enhancing investments.

Recent work by Weller and Singleton (2003) showed that political freedom—including labor standards —is an important determinant of financial stability. Banking and currency crises were much less likely to occur in those nations that have made strong commitments to adopting and enforcing workers' rights. Despite the many intermediating factors at play between labor standards and financial stability, the relationship between the two is robust and significant. Weller and Singleton found that moving one rung further up the civil liberties ranging produced by Freedom House (2002), which ranges from 1 (least free) to 7 (most free) reduces the probability of a currency crisis by 22%.

The evidence also shows that the severity of crises, if they occur, was muted in countries with better workers' rights. After the Asian currency crisis of 1997-98, South Korea fared relatively well in its recovery, while Indonesia fared particularly poorly. Rodrik (1999) found that institutions promoting democratic rights, rule of law, and social safety nets are an important factor in enabling nations to rebound more quickly from economic shocks. Lustig (2002) similarly found that the existence of decent social safety nets is one of the most important crisis-recovery policies a nation can adopt. But democratic rights and social safety nets are much more likely to exist in nations where workers' rights are respected and where labor has a voice in governance.

The Effects of Workers' Rights in Open Economies

There is one caveat, though, that has become increasingly apparent in the empirical literature. As emerging economies have opened their borders to international goods and capital flows, it has become easier for businesses to threaten to leave in search for more business friendly environments, i.e. countries with fewer regulatory institutions, such as workers' rights. Hence, the development and the enforcement of democratic institutions, such as workers' rights, has been hampered by the increasing mobility of international capital. As a result, the benefits from better workers' rights are reduced in more open economies.

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Aside from a number of studies documenting the benefits of political freedoms, there are also some studies that analyzed the effects of economic performance on freedom. Indeed, the failure of open markets to promote democracy in some locations provided the impetus for research on the causal relationship between economics and democracy, and by and large found that some economic trends hamper the development or growth of democratic institutions. Collingsworth et al. (1994) demonstrated that foreign direct investment (FDI) depressed human rights in industrializing countries. Barrientos (1996) analyzed the effect of trade liberalization on women agricultural workers in Latin America and found that trade liberalization without strong labor protections decreased both workers' rights and wages. Ali (1996) similarly argued that FDI undermines weak trade sanctions, offering countries no incentive to democratize or to respect the human rights of local populations. Weeks (1999) concluded, based on macroeconomic data from Latin America, that increased labor market flexibility resulted in a significant deterioration of workers' rights during the 1990s.

Hence, there is some evidence that greater mobility of goods and capital flows in a deregulated, open economy reduces political freedoms, including workers' rights. In particular, more deregulation of trade and capital flows may lead to increases in import competition and in capital mobility, thereby raising the chance that employers will threaten to leave an specific economy if better workers' rights are enforced. Hence, potential wage and employment gains that would have been possible in a less open environment would be less in an economy, where capital can move in and out of more freely. The suppression of enforceable workers' rights in more open economies has two results. For one, beneficial workers' rights are less likely to be developed or enforced if they are developed, and because workers' rights are less likely to be enforced, the short-term profitability of businesses is increased at a time when domestic demand receives a damper. Because of the short-term profit outlook, deregulation euphoria, which creates speculative boom and bust cycles, is also enhanced. At the same time, the seeds for an eventual crisis are sown because demand growth is reduced due to weaker workers' rights. As a final result, more open economies are less stable than more closed ones (Weller, 2001), and there are fewer opportunities for enforceable workers' rights to create a beneficial, more stable macro economic environment (Weller et al., 2003; Weller and Singleton, 2003).

Conclusion

In the debate over global economic rules and regulations, researchers have not lost sight of the most important goal of development economics, poverty reduction. So far, however, the goal of poverty reduction has been an elusive one. Poverty reduction has been limited in its overall extent as poverty rates in emerging economies may have declined slightly, but the number of the poor has risen. Also, successes in reducing poverty have been geographically limited. For instance, poverty has undoubtedly been reduced in urban centers in China, but there are questions about persistent poverty in rural China, and poverty rates have been high and increasing in many other parts of the world.

One of the underlying causes for the lack of success in poverty reduction has been the rise in financial and economic crises in emerging economies. In the era of increased global deregulation of trade and capital flows, more and more emerging economies have experienced financial and economic crises following speculative bubbles. Consequently, policy makers have focused on

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efforts to stabilize their economies as a stepping stone on the way to successful poverty reduction.

Promising venues in stabilizing emerging economies follow two tracks. On the one hand, countries have contemplated to reinstate regulatory hurdles to the free flow of capital, which would provide emerging economies with some measure of independence to decide their own destiny. On the other hand, emerging economies have considered structural reforms to change domestic institutions. The development of local financial institutions in order to reduce the dependence on foreign capital and the establishment of enforceable workers' rights are two policy initiatives that can have the desired effect of stabilizing emerging economies.

Public support for local financial institutions, such as credit unions, postal savings institutions, or public savings banks, will help to raise domestic deposits and thus lower the dependence on foreign capital. As emerging economies need to borrow less on international capital markets to finance their investment needs, they are less exposed to the whims of international capital markets, and thus face a lower chance of financial and economic crises.

In comparison, better political freedoms, especially workers' rights can help to reduce the chance of a currency or a banking crisis. Better worker involvement increases the chance for faster productivity growth and for a more equitable distribution of economic resources. Because the size of the economic pie grows faster and because the economic pie is distributed more equally, workers will end of with more and with better paying jobs. As workers have more money to spend, the chance that firms will invest too much, which is typically the reason for a financial crisis since it raises the chance of bankruptcy, is lowered. Put differently, as more workers have better paying jobs, businesses are more likely to sell all the product they are producing. Hence, better workers' rights can reduce the chance for financial crises, and thus help to increase the chance for successful poverty reduction.

But the impact of workers' rights is likely lower in more open economies than in more closed ones. Not only do more deregulated financial markets face substantially higher chances of financial crises, they also stymie the effective development of enforceable workers' rights. More liberalized trade and capital flows lead to increases in import competition and in capital mobility, thus giving employers more opportunities for credible threats to relocate to other countries if policy makers desire to implement enforceable workers' rights. Thus, the benefits from enforceable workers' rights are lower in more economies than in more closed ones.

Financial and economic crises are the culmination of powerful economic forces, especially following the deregulation of trade and capital flows. There is likely no silver bullet when it comes to designing successful economic policy to stabilize emerging economies. Instead, a number of policy measures are probably necessary to reduce the frequency of financial crises and to put the global economy on track towards successful poverty reduction. Such policies should include, among other things, the development of local financial institutions, the establishment of enforceable workers' rights, and a reconsideration of the elimination of capital controls. Without a multi-pronged policy approach, financial and economic stability and sizeable, broadly shared poverty reduction will remain elusive goals.

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Appendix:

Table 1

		GDP growth		Manufacturing Output Growth		Manufacturing Export Growth	
		before	*after*	*before*	*after*	*before*	*after*
Argentina	1983	-0.2	1	-0.5	0	0.6	2.8
Brazil	1988	5.3	0.9	4.5	-2.2	9.5	4.8
Dominican Republic	1990	4.4	4.5	1.7	4.2	9.1	5.6
Ecuador	1979	7.1	1.3	11.6	2.1	0.4	2.3
Fiji	1987	9.8	5.8	4.2	-0.6	14.3	6.7
Guatemala	1992	4.1	4.1	-	-	5.6	8.6
Honduras	1990	3	3.3	4	3.8	1.9	1.8
South Korea	1987	10.7	8.6	15.7	8.3	15.6	6.9
Panama	1989	-0.5	10.5	-2.5	8.9	0.2	8.9
Peru	1990	-0.9	1.8	-	-	-3.8	-23.2
Phillipines	1987	-1.3	4	-2.4	3.1	2.4	7.2
Suriname	1991	1.7	0.6	-3.2	-2.4	-	-
Taiwan	1987	9.6	6.9	-	-	-	-
Thailand	1992	10.7	8.2	14.7	11.5	17.3	13.2
Turkey	1986	6.1	2.7	7.9	5.7	16.1	8.1
Uruguay	1985	-7.6	4.4	-5.4	3.7	2.7	6.8
Venezuela	1990	2.7	5.2	-3.3	4.5	6.8	3.6
Average		3.81	4.34	3.36	3.61	6.58	4.27

Source: OECD (1997)

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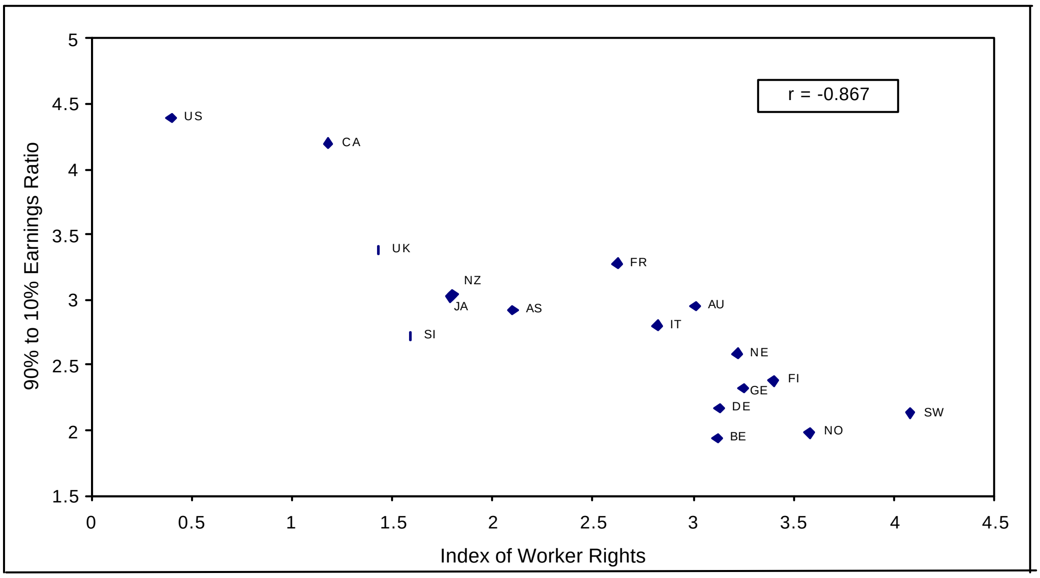
Figure 1. Ratio of Earnings at the Upper Limits of the 9th vs. the 1st Deciles.



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