The emerging truth of going global - ESWAR PRASAD and KENNETH ROGOFF.

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Recent financial crises in the emerging markets have stoked a heated debate about the benefits and costs of financial globalisation. Many countries that have participated actively in the process experienced rapid growth for some years. But subsequent financial crises have been cited as evidence that the deck is stacked against the globalisers.

Too much of the debate about financial globalisation has been based on passion rather than evidence. So, together with Shang-Jin Wei and M. Ayhan Kose, we undertook a study of its effects on developing countries*. The conclusions are rather sobering, suggesting that many developing countries have been unable to get the full benefits although they have borne the full weight of the risks. Since the International Monetary Fund has often been regarded as a cheerleader for financial globalisation, this study attracted considerable attention.

However, our results are more evolutionary than revolutionary. A number of earlier IMF reports and research papers had warned of the problems of moral hazard and the build-up of excessive debt in emerging markets, long before the topic became fashionable. They had also highlighted the dangers of trying to maintain fixed exchange rate regimes not supported by appropriate policies, particularly when accompanied by rampant capital account liberalisation. Our recent paper builds on this research and our main message is far more nuanced than some polemicists seem to realise.

The study focused on two questions. First, does financial integration by itself help a developing country to achieve higher living standards through faster growth? Interestingly, the more financially integrated developing economies do seem to have achieved higher per capita incomes than others. However, it becomes difficult to make a convincing connection between financial integration and economic growth once other factors, such as trade flows and political stability, are taken into account.

The second question was whether financial integration helps a country to avoid macroeconomic instability. We found that financially integrated developing economies have in some respects been subject to greater instability than other developing countries. This result may not seem surprising, in view of recent financial crises. But it is still interesting that it is precisely those countries that made the effort to become financially integrated that, in general, faced more instability.

So, if financial globalisation has not directly resulted in higher growth but has contributed to greater instability, is it something that developing countries would do better to avoid?

While the study's findings do not seem encouraging at first glance, there are important positive policy implications. We found that countries do enjoy the benefits of financial integration, in terms of both higher growth and lower instability, once they have crossed a certain threshold in terms of the soundness of their domestic monetary and fiscal policies and the quality of their social and economic institutions. Countries with strong super-visory structures for the financial sector and little domestic corruption tend to be less susceptible to crises.

One of the main messages of the paper is, thus, quite consistent with the IMF's traditional mantra: that sound macroeconomic policies are important for robust and sustainable growth. But more attention to domestic institutions and financial markets is warranted. Financial globalisation sooner or later exposes weaknesses in these areas: countries with pegged exchange rate regimes, unsound domestic macroeconomic policies and poorly supervised financial markets are more likely to suffer costly financial crises when they expose themselves to international capital flows.

Economic theory leaves a number of complex and crucial questions unanswered. For instance, in order to control the risks associated with opening up to capital inflows, it seems necessary for countries to have strong institutions. On the other hand, inflows of capital, especially foreign direct investment, may bring technological know-how and knowledge of best practices in other countries that can improve domestic institutions. So should a country postpone opening its capital markets until it has good institutions? Or should it use financial integration as a tool to improve its institutions? Unfortunately, there are no definitive answers to these issues, which are best approached by each country based on its own circumstances.

Our reading of the evidence hardly suggests that developing countries should be hastening to carry out rapid capital account liberalisation, and certainly not before trade liberalisation. Yet these countries should also recognise that there are limits to the usefulness of capital controls, which cannot protect a country from the effects of reckless policies. Many recent financial crises have been sparked by excessive government borrowing rather than private borrowing. Slapping on capital controls - which too often are heavy-handed, growth-stifling and corruption-inducing - is hardly likely to solve this problem. Indeed, the effectiveness of capital controls has usually tended to erode with time; as financial globalisation continues, it is likely to diminish further.

* The Effects of Financial Globalization on Developing Countries: Some Empirical Evidence. www.imf.org/research**Eswar Prasad** is division chief in the IMF's Asia and Pacific department and Kenneth Rogoff is chief economist of the fund