Developing countries need to fix domestic problems to best benefit from globalization

Developing countries can benefit from globalization if they fix potential problems at home before opening their economies.

Failing to do so can multiply local problems as money streams across borders, suggests ADBI research. For a number of reasons, developing countries might end up worse off if they allow their currencies to float freely and remove controls on money flowing in and out of their country before putting in place strong financial foundations.

Economists generally agree that imposing controls on capital flows acts as a tax on an economy.

Those controls can make it harder for companies to find investors and for local investors to seek better returns for their money.

What's more, greater integration into the global financial system means a developing economy is less exposed to any volatile growth swings at home.

The potential for international investors to quickly pull out their money can also keep local institutions in line, stopping them from making any moves that are not seen to be for the good of everyone.

If there are problems at home, economic and financial exposure to external markets can make things worse.

If local rules or political meddling push investment toward inefficient sectors, or to cronies of the rulers, allowing more investment can mean even more unbalanced investing.

Often, international investors will be more willing to lend money to such a country than to invest in companies or start businesses themselves to reduce their exposure.

That means that if a crisis hits the global economy, such as the global financial crisis in 2008, looser capital controls could have left these problem economies with high foreign debts that become more difficult to pay as the local currency falls in value.

If local investors don't trust their country's institutions or markets, an open flow of capital could mean money would flow out of a developing country to more developed ones, defeating the purpose of opening a country to the outside world.

Countries that ensure a level playing field for domestic business and investment are better prepared to allow their currencies to fluctuate and for money to flow freely across their borders.

Doing so gives them a much greater chance to benefit from globalization than those that don't.

This episode was based on research done for ADBI by Shang-Jin Wei, a professor at Columbia University's School of International and Public Affairs and Graduate School of Business.

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