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THE ROLE OF DOMESTIC POLICIES IN STABILIZING CAPITAL FLOWS

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The author is Principal Regional Adviser of ECLAC. The views expressed herein are the sole responsibility of the author and do not necessarily reflect those of the Organization. This paper has not been formally edited.

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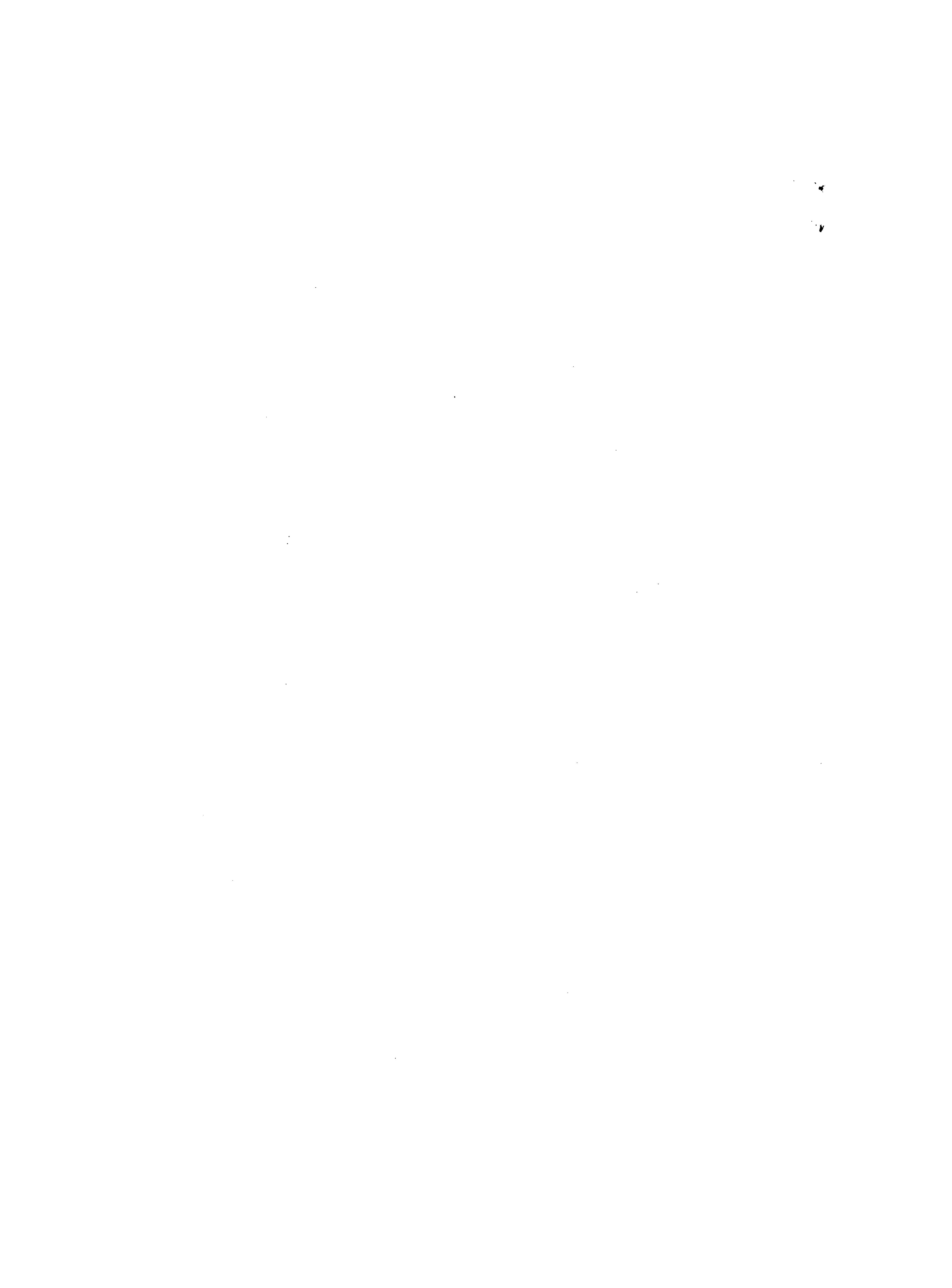

I. INTRODUCTION[*]

Latin America has been strongly affected by the changes that have occurred in capital flows over the last twenty-five years. During the 1970s, a large supply of funds was made available to the region; then, during the 1980s, there was a severe shortage of financing, and the region became a net exporter of funds. Between 1991 and 1994, it became a net recipient of large amounts of funds again, only to experience another sharp reduction of some of the main flows in late 1994 and early 1995, and a renewed access in 1996-97. In 1998-99, Latin America has been experiencing a new shortage of external financing, aggravated by a general worsening of the terms of trade. A crisis centered in Asian countries has now been the origin of a new recessive macroeconomic adjustment in the region.

On all these occasions, the changes that were first expansive and then contractionary, began on the international markets and had a strong impact on the national economies. The successful emerging economies of Asia appeared to be immune to the instability associated with capital surges. The recent events have shown that is not so anymore. Some of the causes are common with those of Latin America. The new crisis provides a renewed opportunity to significantly improve the architecture of the international financial system. Here we concentrate on some features of policies in emerging economies and sketch reforms needed.

[*] Draft for comments.

1. Capital flows to Latin America

During the 1990s, capital inflows contributed to a recovery of economic activity, after the recession that still prevailed around 1990 in most LACs. Annual GDP growth rose from 1.2 per cent in the 1980s to 4.1 per cent between 1990 and 1994 (table 1). This growth was meager, however. On the one hand, the comparison with the previous golden age is shocking. Along the three decades spanning between 1950 and 1980, Latin America had averaged a GDP growth of 5.5 per cent per annum; domestic investment had been rising fast, as a source of that vigorous growth. Subsequently, in the 1980s there was a sharp drop of the investment ratio, of 7 points of GDP, with only a mild recovery in the 1990s. In fact, investment grew much less during this decade, than did capital inflows; thus, most of the external flows financed increased consumption, and crowded-out domestic savings.

Table 1
GROSS DOMESTIC PRODUCT, 1970-98
(Annual growth rates, %)

	1970-80	1980-90	1990-94	1995	1996	1997	1998[a]
Argentina	2.8	-0.7	8.2	-5.0	3.6	8.4	4.2
Brazil	8.6	1.6	2.8	4.2	2.8	3.0	0.2
Chile	2.5	3.0	7.9	10.1	7.3	6.9	3.4
Colombia	5.4	3.7	4.3	6.2	2.2	3.2	0.2
Mexico	6.7	1.9	3.7	-6.6	5.3	7.3	4.8
Peru	3.9	-1.2	5.3	7.7	2.4	7.7	0.7
Uruguay	3.0	0.0	5.2	-2.1	5.3	5.1	4.0
Latin America (19)	5.6	1.2	4.1	0.4	3.5	5.3	2.2

[a] Preliminary figures.

Source: Calculations by the author, based on official figures for 19 countries processed by ECLAC; figures expressed in 1980 US$ for 1970-80, in 1990 US$ for 1980-97 and in 1995 US$ for 1998.

Net capital inflows amounted to nearly 5 per cent of GDP in both 1977-81, 1991-94, and 1996-97. In all three periods, the deficit on current account rose sharply, and exchange rates appreciated (ECLAC, 1995); naturally, imports grew more rapidly than exports, and external liabilities rose steadily. Indeed, all these variables reflect a growing macroeconomic imbalance.[1] Those recipient countries, which had larger deficit on current account and stronger appreciating exchange rates, became increasingly vulnerable to external creditors who, given the high exposure of financial assets placed in the region, subsequently became more sensitive to any "bad news".

Although the growth of international capital markets since the mid-1960s is partly a reflection of the growth of the world economy, including international trade, and the globalization of production, it is also associated with purely financial factors, in which changes have occurred at a much faster pace. During the 1970s and the 1980s, many countries began to liberalize their financial sectors and to relax or eliminate foreign exchange regulations (Díaz-Alejandro, 1985; Devlin, 1989). This, together with the revolutionary advances that have taken place in data-management and telecommunications technology, and the emergence of increasingly sophisticated financial techniques, contributed to a boom of national and international financial flows.

[1] The presence of significant disequilibria, in a framework of repeated statements regarding the need to maintain macroeconomic equilibria, reveals inadequate comprehension of how to achieve those equilibria in order to make them sustainable and consistent with development. See Ffrench-Davis (1999, ch. VI).

The dramatic increase of the flow of international financial resources in recent years has been more diversified during the current decade than it was during the 1970s. But the situation is potentially more unstable, inasmuch as the trend has been to move from medium-term bank credit to investments in liquid stocks, bonds and deposits; a very high percentage of this supply of financing is of a short-term and highly volatile nature.

There is well-documented evidence showing that these changes have originated, to a large extent, in the sources of supply. The boom of the early 1990s occurred mainly in the USA (see Calvo, Leiderman and Reinhart, 1993; Chuhan and Jun, 1995; Culpeper, 1995; Griffith-Jones, 1995). Institutional changes allowed and encouraged outflows; domestic recession in the US, a limited demand for funds, and very low interest rates led investors to seek other markets.[2] Latin America was a receptive destination, and offered the expectation of high rates of return.

Why the high rates of return? Naturally the rate should be higher in capital-scarce regions, like Latin America. But that was reinforced by several conjunctural factors. Prices of stocks and real estate were highly depressed. That allowed a 300 per cent average rate of return (in US dollars) in the stock markets of Latin America (see table 2) between late 1990 and September 1994. Domestic interest rates were high, reflecting the repressive monetary policy in place (plus the nature of financial reforms implemented). Finally, in a non-exhaustive list, the

[2] Between 1989 and 1993, the LIBOR rate in dollars, at 180 days, fell from 9.3 per cent to 3.4 per cent; rates for the same term on the US monetary market fell from 9.2 per cent to 3 per cent (IMF, International Financial Statistics, Washington, DC, various issues). Background on interest rates in Latin America can be found in ECLAC (1995), ch. IX.

recovered supply of external financing generated a gradual exchange-rate appreciation (see table 3) that encouraged short-term inflows; that is, for dealers operating with terms within the horizon of expected continued appreciation of the domestic currency.

Table 2
INDICES OF STOCK EXCHANGE PRICES, 1990-98[a]

Month-year	Dec. 1990	Aug-Oct. 1994	Dec. 1994	March 1995	Dec. 1995	Dec. 1996	June 1997	Dec. 1997	Dec. 1998
Latin America[b]	24.1	100.0	80.9	58.6	66.4	76.9	106.2	96.2	59.4
Argentina	17.3	100.0	77.5	63.4	84.2	100.1	121.9	117.3	84.0
Brazil	11.7	100.0	91.6	67.4	71.3	93.1	143.2	112.1	64.3
Chile	25.9	100.0	100.8	94.9	97.9	81.0	105.3	83.8	58.6
Colombia	15.0	100.0	93.4	88.6	69.6	72.7	90.3	90.2	50.9
Mexico	30.0	100.0	62.6	32.7	45.7	53.7	68.7	78.4	47.8
Peru	-	100.0	104.8	87.4	114.6	115.4	156.8	131.4	79.2
Venezuela	170.8	100.0	91.6	75.0	62.6	145.2	191.8	179.0	86.2

[a] Values at end of period, expressed in US dollars.
[b] Average of the seven countries considered, weighted by amount of transactions.

Source: Indices based on series in International Finance Corporation, *Monthly Review of Emerging Stock Markets*, several issues.

When creditors discover an emerging market, they start out with non-existent exposure. Then they generate a series of consecutive flows which accumulate in rapidly increasing stocks. As said, the creditor's sensitivity with regard to bad news increases remarkably with the level of stocks placed in a country (or region), and with the degree of dependence of the debtor on additional flows (current account deficit plus refinancing of maturing liabilities). Additionally, after a significant rise in stock prices and exchange-rates, accompanied with rising stocks of external liabilities, the probability of reversal of expectations grows steeply.

The new supply of financial flows initially had a positive effect on Latin America: thanks to a better utilization of installed capacity, production increased, beyond the expansion of output capacity, by US$70 billion in 1994 in comparison with 1990. That is, about one third of the 4 per

cent rate of annual growth in GDP in 1991-94, corresponded to an increased use of installed capacity. The phenomenon was particularly intense in countries such as Argentina and Peru.

Table 3
REAL EXCHANGE RATE INDICES, 1983-98[a]
(1987-90 = 100)

	1983-86	1987-90	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	78.5	100.0	66.1	61.5	58.1	60.3	66.5	67.9	65.4	63.6
Brazil	117.2	100.0	97.2	104.8	96.8	85.5	69.5	64.6	63.2	64.5
Chile	68.8	100.0	100.1	96.5	98.1	97.2	92.7	88.0	80.7	81.3
Colombia	65.1	100.0	111.6	98.8	95.6	82.5	82.6	78.3	73.5	76.8
Mexico	96.0	100.0	81.0	74.6	70.9	72.7	107.2	96.7	84.2	83.4
Peru	136.4	100.0	55.4	55.4	57.3	56.6	57.0	55.0	53.7	53.4
LACs average (18)										
Weighted	97.4	100.0	88.5	87.9	83.3	79.2	82.5	79.2	74.7	74.5
Simple	85.8	100.0	97.5	96.4	95.0	93.4	95.0	93.4	88.1	87.0

[a] Annual averages of real exchange rate indices (main official) for each country with respect to the currencies of their main trading partners, weighted by the share of exports to those countries; inflated by external CPI and deflated by domestic CPI; for Brazil we weighted the Rio CPI index ($^2/_3$) and the new official series of inflation ($^1/_3$).

Source: Calculations by the author, based on official figures for 18 countries processed by ECLAC.

The increased availability of external financing was clearly beneficial during those years, inasmuch as it removed the external constraints that had been responsible for the one-decade recession of the region. However, renewed access to external capital also posed challenges in regard to the stability and sustainability of macroeconomic equilibria, thus jeopardizing chances for attaining sounder development. Indeed, the affluence of capital also had an adverse effect on the evolution of exchange rates,[3] the money supply and domestic credit, the accumulation of external liabilities (mostly with short-term maturities), and thus made the economy more vulnerable to future negative external shocks.

[3] It should be recalled that several LACs were implementing sharp liberalization of import regimes *pari passu* with exchange-rate appreciation. See Ffrench-Davis (1999, ch. III) and ECLAC (1995), ch. V.

External financing is obviously a vital ingredient of development; however, it also tends to be very volatile, and to fluctuate between excessive surpluses and shortages. Consequently, it is important to design economic policies that will attract resources, but which will ensure that they flow in a fashion and quantities that are sustainable and are directed more towards long-term investment rather than to consumption.

The Mexican crisis which exploded in 1994 is a good example of the harm that can be caused when a country absorbs an excessive volume of capital inflows, giving way to a large stock of external liabilities, especially when the composition of such financing makes it volatile. Producers and consumers adjusted to a level of overall expenditure that was much higher than potential national GDP, and after a while the amounts involved became unsustainable. Recessive adjustment inevitably followed. The 6.6 per cent drop in GDP and the nearly 30 per cent drop in capital formation which occurred in Mexico in 1995 were closely associated, first, with a persistent appreciation in the exchange rate and a growing deficit on current account, and subsequently with a sharp cutback in financing on the part of creditors which forced the country into a highly recessive adjustment and a huge devaluation, despite the large package of international support it received in 1995 (Lustig, 1996).

It is wrong to say, as is said surprisingly often, that the Mexican crisis of 1994 could not have been foreseen because of the concealment of information. While it is true that official information on international reserves was provided only sporadically, the key data concerning the exchange-rate lag and the high current account deficit, and the fact that it was financed with

volatile resources, were available on a regular basis. Notwithstanding this, by 1993 praise of Mexican policies was generalized in financial institutions and media.

Essentially, the seeds of the crisis date back to the period between 1992 and 1994, when there was a massive capital inflow, mostly short term. Aggregate demand grew rapidly leaving far behind the potential GDP; it leaned increasingly towards tradable goods, especially encouraged by exchange rate appreciation.[4] Thus, in those years, there was a maladjustment that would inevitably have to be reversed in the future. What is extremely important is that disequilibrium was led and encouraged by capital inflows. Since the public sector was balanced, the disequilibrium was located in the private sector.

However, the crucial problem was that neither those on the supply side nor those on the demand side paid enough attention to the available information until after the crisis erupted. Indeed, the most influential financial operators usually act with a very limited set of data. This explains why they may suddenly change their minds radically about the economic situation of a country or of a firm.

In 1995, the Mexican crisis did not have a widespread effect throughout the region, as it had in 1982. The Argentine economy, however, was seriously affected by the so-called Tequila Effect. Although this did not lead to a crisis in the sense of a sharp exchange rate devaluation, as

[4] Despite the fact that expenditures exceeded GDP, production capacity was probably larger than actual GDP, with an underutilization of the production capacity of importables and of potentially exportable goods under a less appreciated exchange rate. This might explain the subsequent sizeable response of the output of tradables to the real devaluation in 1995. See interpretations of the Mexican crisis in Gurría (1995), Ros (1995) and Sachs, Tornell and Velasco (1996).

some operators had feared in 1995, Argentinean GDP fell by 5 per cent and investment diminished by 16 per cent. The overall growth rate of Latin America went down sharply, to almost zero, while the regional investment ratio also fell substantially. During 1995, in diverse countries, negative flows had been observed in several segments of the supply of funds (especially bonds, deposits and to stock markets). By early 1996, several countries showed GDP drops in various quarters. In fact, average growth in Latin America was negative in the four quarters included between March 1995 and 1996.

Subsequently, the flow of funds was reactivated once again, exceeding $80 billion in 1997. The resulting economic reactivation was particularly significant that year. However, some of the same problems displayed in the 1991-94 recovery threatened to reappear in 1996-97, and actually collected a bill in 1998-99. Positive features in 1995-97 were: a tendency to increment the share of FDI inflows, which are more steadfast than flows to the stock market or short-term credits; a sharp reduction of the current account deficits in 1995 (and a significant exchange rate depreciation, particularly in the case of Mexico); taking into consideration the banking crisis of Mexico and Argentina, following the "tequilazo", these and other countries introduced reforms to their financial reforms which strengthened the prudential regulation and supervision of their banking systems. However, during 1996-97 most LACs appreciated their exchange-rates (see table 3) and their deficit on current account rose sharply. The same old story was returning to the scene.

2. Reducing vulnerability: the case of Chile

Chile displayed a performance opposite to that of Mexico in 1995-96, regardless of numerous similarities during the years prior to 1994. The most pronounced divergences refer to macroeconomic policies more related to the external sector (mainly capital movements regulation, exchange rate policy, and prudential supervision of the financial system) before the crisis.

Both the Mexican crisis and Chile's strength were built up over time. Towards the end of the 1980s, both countries had already opened up their trade considerably, their budgets had improved substantially, privatization was well under way, annual inflation was around 20 per cent, and the two countries had similar domestic savings rates. The reason why Chile performed better in 1995 is that, faced with an abundance of external funds in 1990-94, it deliberately followed a cautious policy (Stiglitz, 1998). Instead of taking and spending all the large supply of external resources available, which would have led to a significant appreciation of the peso and to a rising deficit on the current account, it chose to discourage short-term capital inflows. In 1991 a tax was imposed, and substantial non-interest-bearing reserves for external credit were required; the reserve requirement was subsequently extended to deposits in foreign currencies and investment in second hand stocks, while primary issues and venture FDI capital were exempted;[5] FDI had to be held in Chile for one year at least; the financial system was subject to relatively strict prudential regulation, including a selective supervision of assets and required

[5] The rate of the reserve requirement, that had to be kept at the Central Bank for one full year, was reduced from 30 per cent to 10 per cent by the end of June 1998 and to zero in September, in order to accommodate to the

provisioning, as well as restrictions and drastic penalties on operations with related parties (Agosin and Ffrench-Davis, 1998). The set of measures adopted effectively discouraged inflows of speculative capital (Ffrench-Davis, Agosin and Uthoff, 1995; Agosin, 1998).

This is one of the main reasons why, in late 1994, Chile had a moderate external deficit, high international reserves, a modest and manageable short-term debt, a domestic savings rate that was rising instead of falling (the latter being the case in Mexico and Argentina), a level of domestic investment that since 1993 has been the highest recorded in its history, and the exchange rate in 1990-94 was comparatively closer to equilibrium (see table 3) than that of most of the countries of the continent, as reflected by a moderate deficit on current account (table 4).

Table 4
DEFICIT ON CURRENT ACCOUNT, 1983-98
(US$ millions per year)

	1983-90	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	1.413	647	5.462	7.672	10.118	2.768	3.787	9.454	12.200
Brazil	1.564	1.450	-6.089	-20	1.153	17.972	24.347	33.484	32.450
Chile	999	99	958	2.554	1.585	1.398	3.744	4.058	5.160
Colombia	671	-2.347	-876	2.219	3.113	4.366	4.946	5.683	6.060
Mexico	241	14.888	24.442	23.400	29.418	1.576	2.330	7.449	15.500
Peru	1.030	1.509	2.101	2.302	2.662	4.298	3.619	3.408	4.120
Latin America (19)	6.967	17.426	34.350	44.920	49.566	34.449	36.659	63.669	83.905
L.A.-Venezuela (18)	8.642	19.162	30.601	42.927	52.107	36.463	45.573	68.353	82.345

Source: Calculations by the author, on the basis of official figures processed by ECLAC. The balance on current account includes private and public unrequited transfers as current income. In 1994, private transfers amounted to US$9.5 billion and public transfers totaled US$2.5 billion.

Policy has been effective in achieving its targets in most part of the 1990s. However, in 1996-97 this policy mix and the intensity with which it was applied remained unchanged, in spite of a new vigorous surge in capital flows to most countries in the region. This surge should have

new shortage of external financing associated to the Asian crisis.

been met with increased restrictions on rising inflows. But the fact is that, in general, the intensity of policy was kept rather unchanged.

As a consequence of such lack of action on capital inflows during 1996-97, despite heavy intervention in foreign exchange markets, the Central Bank was unable to prevent a sharp real exchange-rate appreciation and rise of the deficit on current account. Evidently, as said, the new surge should have been met with an increased reserve requirement or other equivalent measures. Nonetheless, the benefits of the active regulation implemented in previous years, had left large international reserves, a low stock of foreign liabilities and a small share of volatile flows. Unfortunately, those strengths were partially undermined by the excessive exchange-rate appreciation and high deficit on current account recorded in 1997.

The Asian crisis has been felt principally through trade. In fact, the terms of trade of Chile worsened in the equivalent to 2.5 per cent of GDP, with reduced access to external markets, in a country that sells 30 per cent of its exports in Asia and that exhibits exports highly intensive in commodities.

3. Emerging East and South-East Asia: the new casualty of financial instability

During 1995 there were negligible effects of the Tequila crisis over the Asian region. This was so even in economies with large deficits on current account. As a consequence, the year 1996 saw many outstanding researchers and observers asserting that those deficits were not relevant if investment ratios and growth were high. Thailand and Malaysia were two of those cases.

A few Asian countries had rather free capital flows, but several of them had regulated capital inflows and exchange markets successfully for long periods (Helleiner, 1997; see the cases of Malaysia, Indonesia and Thailand, in Sachs, Tornell and Velasco, 1996) and many had executed effective second-level sterilization policies (Reisen, 1993). Growth was actually sustained and extremely high. In 1980-95 GDP yearly growth averaged between 6 per cent and 8 per cent in the Republic of Korea, Indonesia, Malaysia and Thailand; the investment ratio exceeded 33 per cent, with domestic savings ratios close to that notable level; inflation was low (in the 5 per cent annual range) and fiscal budgets were generally balanced or in surplus. In the meantime, the average GDP growth in Latin America was 2 per cent and the investment ratio fluctuated around 20 per cent.

What explains the sudden inverted comparative perceptions of Asia and Latin America in 1997?

First, what works for some time might see its efficacy reduced after a while. A relevant feature relates to exports. In fact, recently the exports of several Asian economies were experiencing problems. What had been until then products with a notably dynamic demand appeared to be reaching maturity, facing tightening markets (Sachs and Radelet, 1998).

Second, even if exports wellbehave, a disequilibrium can emerge if imports experience a boom. In both Korea and Thailand imports rose sharply in 1995-96. This boom was related to expanded aggregate demand and to cheaper imports (due to some import liberalization together

with exchange-rate appreciation, a recent Latinamericanization of some Asian economies). Rising capital inflows were behind both factors.

Third, good sustained policies can be reversed under exogenous pressures. The strong drive towards financial liberalization prevailing in the world today had also permeated Asia in the 1990s. Actually the deficits on current account increased substantially in Korea and Thailand since 1993. Data shows that they were not led by public deficits and did not imply losses of international reserves. Neither were they due to an exogenous increase of private expenditure. On the contrary, the cause was a private expenditure rise led by short term capital inflows. In Korea, Indonesia, Malaysia and Thailand international reserves were accumulating persistently between 1992 and early 1997, fed by capital inflows, pressing local authorities to purchase foreign currency. Consequently, international reserves more than doubled in those countries in that period. It was a phenomenon led by capital inflows which sustained appreciating exchange rates (though a moderate trend) and a strongly increased aggregate demand (with a significant enlargement of the deficit in current account of 4.4 points of GDP in Korea, 2 points in Indonesia and 3 points in Thailand).

The additional financing was mostly short term (IMF, 1998; Sachs and Radelet, 1998). Inflows contributed to a domestic lending boom, with bubbles in real estate and stock market prices. Weaknesses in prudential supervision of the financial system, not so relevant in the previously repressed domestic markets, became evident. But it is also evident that poor supervision was not the main cause, but just a reinforcing factor in the macroeconomic disequilibria which was built in the last three years, in a region that had exhibited a spectacular

performance for a long time. The disequilibrium was only recognized by financial markets in 1997 and charged a high bill in 1998. The policy failure was an error shared with the financial reforms of Chile in the seventies and of Mexico in the nineties.

The East and South-East Asian countries have experienced deep recessions in 1998. Subsequent to two or three decades of a solid annual growth of 6 to 8 per cent, many of them experienced in 1998 significant drops. Indonesia presents a 15 per cent contraction, similar to the spectacular drop of Chile in 1982. For Korea, Malaysia and Thailand reductions of around 7 per cent are estimated, and additional declines are expected in most of those countries during 1999. These recessions are comparable to those of Latin America in 1982-83, with drops in productive investment, banking crises and social decline.[6]

4. Lessons for Latin America once again

Optimism regarding Latin America returned to the international financial markets in 1996-97. The current net capital inflow climbed to the pre-crisis levels. Composition improved, with a larger share of FDI. GDP decline in various LACs was reversed. In fact, a dynamic growth for the region as a whole was observed since mid-1996 until mid-1998.

Nevertheless, it should be noted that GDP increase comprised a large recovery share; that is, effective GDP was once again close to the production frontier. However, the frontier moved

[6] See various interpretations of the Asian crisis in Krugman (1998), Perry and Lederman (1998), Sachs and Radelet (1998), Stiglitz (1998b), Wyplosz (1998).

upward slowly, because productive investment was still low, while real exchange rates were retaking an appreciation path. Consequently, as long as productive investment does not increase substantially (and it is still notably lower than what it was during the golden decades in East and South-East Asia), that rate of growth is not sustainable. In effect, at the beginning of 1998 it was foreseen that the 5.2 per cent growth of 1997 would moderate to around 4 per cent. With the intensification of the Asian crisis and its contagious effects, the effective growth is estimated to have contracted to 2.2 per cent in 1998 (ECLAC, 1998).

Additionally, the Asian crisis will worsen the terms of trade and the access of Latin American exports. Then the region will experience a new adjustment, though now without a so deep crisis. The future, however, will depend on whether the region and the most influential people (i.e. the international institutions and the US) have learnt the lesson. There are very mixed signals.

GDP recovery in Argentina and Mexico has been particularly vigorous, although after the sharp decline in both countries with the Tequila Effect, there was a large gap between effective GDP and productive capacity. This enabled a significant reactivation to take place. Nevertheless, in both countries GDP per capita only during 1997 was approaching the levels achieved in 1994, while average wages were still lower. Rather than being a consequence of policies adopted in 1995-96, this is the result of policies implemented before the crisis. The following lessons can be derived from them.

a) *Level, composition and sustainable uses of flow*

It is important to ensure that the inflow of funds is directed to productive investment; allowing too much to drain off into investments on the stock exchange and consumption of imported goods will create bubbles and imbalances that would be unsustainable. Additionally, fast rising stocks of external financial liabilities tend to be increasingly dangerous.

Opening up the capital account indiscriminately can be very detrimental to productive development and to the welfare of the majority of people, inasmuch as externalities and other imperfections of international capital markets give rise to frequent cycles of abundance and shortage of external financing (Rodrik, 1998). The instability of exchange rates and of macroeconomic indicators, that is usually associated with unrestricted openness, is always very costly in terms of production and equity. Effective, efficient regulation is possible; Chile proved this from 1991 onwards, and Colombia did so during the 1970s as well as in recent years (Urrutia, 1996; Ffrench-Davis and Reisen, 1998).

b) *Avoiding outlier prices and ratios*

Governments must ensure that capital flows do not generate atypical (outlier) prices or significant distortions of basic macroeconomic indicators, such as interest rates and real exchange rates, the composition of expenditure in terms of consumption and investment, and the production of tradables.

Capital inflows should not be used for achieving an extreme objective related to a single domestic economic variable, such as to halt inflation, by appreciating the real exchange rate. This tends to throw other major variables off balance. It is very risky to discard implementing an exchange rate policy by remaining bound to a fixed nominal rate. The methods of regulating the exchange rate can be extremely diverse; several of them involve some form of an exchange-rate crawling-band, with some type of intra-marginal intervention (Williamson, 1996).

The recent experience of Latin America has shown dramatically that allowing the market, dominated by agents with short horizons, to determine the volume and composition of capital flows can have a very high cost for the recipient country. This is why the use of regulations on capital inflows should not be neglected *a priori*. On the contrary, the microeconomic costs associated with the use of such instruments should be balanced against the social benefits in terms of macroeconomic stability, investment and growth (Williamson, 1993; Zahler, 1998).

c) *Consistent sequencing*

With regard to the sequence of reforms, it is generally agreed that the opening-up of the capital account was premature and should have been postponed until other major reforms had been consolidated and new equilibrium prices had been established. The lesson to be learned from this experience is that during structural adjustment, with open capital accounts (especially when international financing is abundant) the capital flows can increase too fast and have destabilizing macroeconomic and sectoral effects (Edwards, 1989; McKinnon, 1991).

In the first place, in the particular case of Latin America, many countries conducted deep trade reforms in the 1990s *pari passu* with exchange-rate appreciation. Second, if productive investment capacity reacts slowly and/or with a lag and domestic financial markets remain incomplete and poorly supervised, additional external resources cannot be absorbed efficiently in the domestic economy, and thus they threaten the future stability of the flows themselves. In the third place, fiscal parameters need to be consolidated, since in the absence of a sound tax base and flexible fiscal mechanisms the authorities will have to depend excessively on monetary policy to regulate aggregate demand. Finally, since part of the aggregate demand generated by capital flows is inevitably spent on non-tradable goods, when actual demand comes close to the production frontier, the relative price of non-tradables tends to rise. This in turn is reflected in a higher current-account deficit. A real revaluation of the currency can obviously distort the allocation of resources and investment, seriously weakening the structural mid-term objective of penetrating external markets with new exports (ECLAC, 1995; World Bank, 1997).

d) *Flexible selective regulation*

It is not wise to make an inflexible commitment to indiscriminately keeping the capital account open, particularly in light of the crucial importance of macroeconomic stability, along with the disproportionate volume of the international capital markets compared with the small size of LACs markets, and the serious shortcomings of both markets. As long as market movements depend to a significant extent on short-term transactions and domestic securities markets remain shallow, there will be a risk of great instability in this new modality of linkages with the international economy. In fact, Mexico's and Thailand's recent critical experiences attest

to the wisdom of discouraging large financial inflows and increasing accumulation of short-term external liabilities. There is growing evidence that the greater the instability of flows (or deviation from the trend), the lesser the share directed to productive investment (Uthoff and Titelman, 1998).

Understanding better the working of domestic and international financial markets is at the core of the future of the world economy. More pragmatism and more systematic efforts should be at work.

5. Avoiding financial crises with a reformed international architecture[7]

Reforms to the international financial markets must come to the support of the intense reforms taking place in emerging economies. Finance has been at the heart of economic crises of international dimension. It played a crucial role in the Latin American debt crises in the 1980s, as it did also, during the present decade, in the Mexican foreign exchange crisis and the 1995 Argentine recession. Most recently, it has been a determinant factor in the current Asian crisis. The uncertainty generated by these crises ends up undermining the development process and affecting the well-being of vast numbers of people.

[7] See ECLAC (1999) and the papers of J. A. Ocampo and S. Griffith-Jones for this seminar.

A common factor in these recent crises has been the great volatility of the most rapidly growing segment of international financial markets: short-term and speculative funds. The causes of this volatility can, in part, be attributed to shortcomings in macroeconomic coordination between the countries that are most influential in global markets and to the weaknesses of international institutional arrangements, for example in the areas of regulation and of policy and information coordination at the global level. These deficiencies are inconsistent with a balanced and efficient globalization process. More energy is being spent on resolving crises than on avoiding them.

The countries that are the recipients of funds have, in principle, some freedom to establish their national policies with regard to capital flows. They can passively allow the effects of external changes to be transmitted to their domestic markets, or they can attempt to moderate or spread these effects over time, influencing the level and composition of capital flows and softening their effects on the exchange rate and domestic aggregate demand. It has been the predominant practice, in times of booming flows, for recipient countries to be encouraged and praised by the international financial institutions and financial specialists to accept all the resources offered. The recriminations concerning the resulting excessive indebtedness have come later, partly from these same sources of praise, in the periods of massive outflows. There is an obvious contradiction between these two attitudes.

The latest crises have highlighted two negative aspects associated to financial flows: the herd-volatile behavior of flows and the great vulnerability of developing economies to the shocks from international financial markets. With respect to the first of these phenomena, it is to be

stressed that while there has been an obvious lack of appropriate prudential regulation of domestic financial markets in most of the Asian countries affected by the crisis, there has been an even more notorious lack of appropriate international institutions to monitor such a sophisticated, but unstable, financial market. The successive waves of over-expansion followed by financial panic indicate that the market tends first to grow overshootingly and then to contract more than is justified by the economic fundamentals.,

The financial operators evidently fulfil a useful microeconomic function as intermediaries between savers and users of funds. However, in practice, and perhaps without wishing to do so, they have come to play a role that has significant macroeconomic implications. With their ratings (in the case of the agencies) and their expectations made widely known in the economic press (in the case of financial operators), they have contributed to intensify the financial flow towards "successful" countries, thus facilitating continuous rises in financial assets (stocks and bonds) and real estate prices, and sharp exchange rate appreciations in the recipient markets. Apart from the quality exhibited by prudential supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, wrongly, to be very efficient and sustainable (with good profits and loan guarantees supported by high prices on stock exchanges and low value in domestic currency of debt denominated in dollars). But in reality bubbles are being generated, which sooner or later must burst. When that happens all these signals and the risk ratings are reversed, in a sharp procyclical fashion.

It is a good time to reconsider the international financial order. Contrariwise, it is a bad time in which to be imposing additional liberalization on this market, an issue that was being

debated in the context of changing the IMF statutes to grant it a mandate in the area of capital account convertibility and of approving a Multilateral Agreement on Investment at the OECD. This would be a grave error. How quickly, it seems, the harsh lessons of the Mexican crisis were being overlooked and the costly adjustments in the wake of financial upsets viewed with complacency.

In closing this paper, we would like to emphasize two points. The first is that, as Alan Greenspan, the Chairman of the US Federal Reserve Board, and José Antonio Ocampo, the Executive Secretary of the UN Economic Commission for Latin America and the Caribbean (ECLAC) have pointed out, the focus of attention should be the management of the booms, rather than the crises, since the latter are, in many respects, the inevitable consequence of badly managed booms. This approach is of the utmost importance, given that the existing institutions and instruments have not been effective in warning of impending turbulence and thus help to prevent unsustainable booms from developing. The second point is the need of an appropriate regulatory framework at the domestic level and the adoption of national measures aimed precisely at controlling booms which the authorities consider to be unsustainable. Noteworthy among such measures are the reserve requirements on financial inflows that Chile has been using with success in times of capital surges.

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