
informes y estudios especiales

Financial crises and national policy issues: an overview

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Abstract

In this overview we analyse, first, why funds continued to flow towards emerging economies, while fundamentals in host countries had been deteriorating before the Asian crisis (a rising external deficit, with a significant liquid component; appreciating exchange rates; low capital formation, particularly in Latin America), and why funding remains dry for long since 1998; the role of the nature of the predominant agents and of a process of flows rather than one-shot building of stock of foreign capital are stressed. Then, the analysis focuses on the interrelations of capital flows and fiscal, monetary, exchange rate and bank regulation policies, building on the papers prepared by participants in this project and related recent references. Finally, some policy implications are presented for boom and bust stages of inflows-led cycles.

JEL classification: E6, F21, F32, F41, F43

Introduction

In recent years, a "new" variety of crises has developed in Asia and Latin America, with four features that differentiate them from the "old" type. First, international capital markets have been the major source of shocks, both positive and negative, to emerging economies (EEs). Second, capital flows have largely taken place between private suppliers and demanders. Fiscal deficits have, on the contrary, played a secondary role and, indeed, in most experiences public finance has been in balance or surplus (i.e., Korea and Thailand before 1997; Argentina and Mexico before the late 1994 Tequila Crisis). Third, these financial crises have been suffered by EEs that usually were considered to be highly "successful" by IFIs, risk rating agencies and the financial press. Fourth, these flows have been characterized by a lack of (or incomplete or procyclical) regulation and supervision, on both the supply and demand sides. Domestic financial systems in recipient markets have often been liberalized without the parallel development of a significant degree of prudential regulation and supervision, while the new sources of supply have grown, usually, unregulated.

In section I, the interplay of supply and demand is discussed, especially stressing the procyclical interrelations; they involve processes rather than one shot changes, short-termish agents are the more active dealers, and there are natural long-lasting differences in relative prices in EEs versus developed economies. All these play a crucial role in explaining flows and their macroeconomic effects. Section II focuses on capital flows, bank regulation, fiscal, monetary and exchange rate policies, and their implications for the sustainability of macroeconomic balances. Section III presents selected policy implications.

I. The interplay of the supply and demand of funds

The dramatic increase of international financial flows in recent years has been more diversified during the 1990s than in the 1970s (see Griffith-Jones, in this volume). But the outcome is potentially unstable, inasmuch as the trend has been a shift from long-term bank credit, which was the predominant source of financing in the 1970s, to portfolio flows, medium- and short-term bank financing; time deposits; non-greenfield FDI (acquisitions). In fact, a very high share of the newer supply of financing is of a liquid nature. Thus, paradoxically, there has been a *diversification toward volatile sources of financial flows* in the 1990s; the relative improvement after the Tequila crisis, with a rising share of FDI,¹ still included a significant proportion of volatile flows.² The foundations of a broad liquid market for portfolio investment, that were laid down with the Brady bonds in the late 1980s, developed vigorously in the 1990s, with Latin America as a major destination for both bond and stock financing; this market offered the expectation of high rates of return during the upswings of the two cycles in the 1990s (see Ffrench-Davis and Ocampo, 2001).

Meanwhile, East and South East Asian countries were just starting to walk into *vulnerability zones* during the first half of the 1990s (Agosin, 2001; Akyüz, 1998; Furman and Stiglitz 1998; Radelet and Sachs, 1998; Jomo, 1998), with mismatches in the

¹ The direct positive link between FDI and productive investment (Ffrench-Davis and Reisen, 1998, ch.1), was weakened by the fact that a significant share of FDI corresponds now to mergers and acquisitions instead of creation of new capacity. It is estimated that mergers and acquisitions covered 49% of FDI to Latin America in 1995-2000 (UNCTAD, 2001).

² The accelerated growth of derivatives markets contributed to soften “microinstability”, but has tended to increase “macroinstability” and to reduce transparency. See an analysis of the channels by which stability and instability are transmitted in Dodd (in this volume).

maturity structure of the balance sheets of domestic financial intermediaries proving to be even more severe than a worsening net debt position (Krugman, 1999).

As a consequence, in contrast with the 1980s debt and the 1995 Tequila crises, both regions moved into *vulnerability zones* (some combination of large external liabilities with a high short-term or liquid share, a significant external deficit, an appreciated exchange-rate, high price/earnings ratios in the stock market, plus low domestic investment ratios in Latin American countries (LACs)). The outcome is, then, an economy increasingly sensitive to adverse political or economic news (Calvo, 1998; Rodrik, 1998). The longer and deeper the economy's penetration into those zones, the more severe the *financierist trap*³ in which authorities could get caught, and the lower the probability of leaving it without undergoing a crisis and long-lasting economic and social costs.

By the end of the second upswing (in 1997), several economies, in both Asia and Latin America, had penetrated deep into the *vulnerability zone*, which was reflected in severe crises in both regions when the mood of the external financial market changed, first with respect to East-Asia and then with respect to Latin America.

One of the strong features of capital flows in the last quarter of a century is the overshooting of supply in both sides of the cycle. There has been contagion, both of optimism and pessimism. The latter, today feeds the view that market dryness to EES is permanent. I work under the hypothesis that the present drought, even though it has lasted long, is temporary, and that the financial setting will tend to generate a new boom and subsequent crisis, unless policies and institutions are reformed domestically and internationally (see Ocampo, 2002a; ECLAC, 2002a, 2002b; United Nations, 2002).

The literature emphasizes, as sources of financial instability, the asymmetries of information between creditors and debtors, and the lack of adequate internalization of the negative externalities that each agent generates (through growing vulnerability), that underlie the cycles of abundance and shortage of external financing (Rodrik, 1998; Krugman, 2000; Stiglitz, 2000).⁴ Beyond those issues, as stressed by Ocampo (2002c), finance deals with the future, and evidently concrete "information" about the future is unavailable. As he states, the tendency to equate opinions and expectations with "information" is confusing. All the above contribute to herd behaviour, transborder contagion and multiple equilibria.

But, over and above these facts, there are two additional features of the creditor side that are crucially important. One feature is the particular *nature of the agents* acting on the supply side. There are asymmetries in the behavior and objectives of different economic agents. The agents predominant in the financial markets are specialized in short-term liquid investment, and are highly sensitive to changes in variables that affect returns in the short-run.⁵ In fact, short-term horizons are a significant part of the story of the 1990s, as reflected in the volatility of flows that characterized the boom-bust cycles. The second feature is the gradual spread of information on investment opportunities. In fact, agents from different segments of the financial market became gradually drawn into the international markets as they took notice of the profitable opportunities offered by EEs. This explains, from the supply-side, why the surges of flows to emerging economies —in 1977-1981, 1991-1994 and 1995-1997— have been *processes* that went on for several years rather than one-shot changes in supply (Ffrench-Davis and Ocampo, 2001).

³ By "financierist" we mean a macroeconomic policy approach that leads to an extreme predominance of or dependency from agents specialized in microeconomic aspects of finance, placed in the short-term or liquid segments of the capital markets.

⁴ There is a different issue, also relevant, associated to the gap between average (private) and marginal (social) costs of borrowing by EEs. See Harberger (1985).

⁵ Persaud (in this volume), argues that modern risk-management by investing institutions (such as funds and banks), based on value-at-risk measured daily, with limits set for daily earnings at risk, works pro-cyclically in the boom and busts. Procyclicality is reinforced by a trend toward homogenization of creditor agents.

On the domestic side, high rates of return were potentially to be gained from capital surges directed to Latin American economies that were experiencing recession, depressed stock and real estate markets as well as high real interest rates and initially undervalued exchange-rates. Indeed, in the early 1990s, prices of equity stocks and real estate were extremely depressed in Latin America. That allowed for a 300% average capital gain (in current U.S. dollars) in the stock markets of Latin America between late 1990 and September 1994 (see table 1), with rapidly rising price/earnings ratios. After a sharp drop of prices —over 40%— around the time of the Tequila crisis, with contagion to all Latin American stock markets, average prices nearly doubled between March 1995 and July 1997, pushed up directly by portfolio inflows (see IMF, 1998).

The case of East Asia was quite different to that of Latin America in one respect: The East Asian economies were growing vigorously, with a high ratio of capital formation, financed by domestic savings. On the contrary, there are several similarities that I want to stress: When many countries opened their capital accounts in the early 1990s, the international supply of funding was booming; as well, equity stock was cheap as compared to capital-rich countries (exhibited low price/earnings ratios), and external liabilities were low. The expected outcome in any emerging economy moving from a closed to an open capital account should tend to be similar to that recorded in LACs. In fact, naturally, the rate of return tends to be higher in the productive sectors of capital-scarce EEs than in mature markets that are capital-rich. Then, there is space for very profitable capital flows from the latter to the former. The outcome expected actually also occurred in the case of East Asia, whose stock prices doubled between 1992 and 1994, and deficit on current account and real exchange-rates rose.

Table 1
LATIN AMERICA AND EAST ASIA: STOCK EXCHANGE PRICES, 1990-2002
(Indexes July 1997=100)

	Dec-90	Sep-92	Sep-94	Mar-95	Jul-97	Aug-98	Mar-00	Sep-01	Mar-02	Jun-02
A. Latin America (7)	21.7	44.6	92.5	52.3	100	47.2	88.3	54.8	71.8	60.8
Argentina	13.4	46.9	78.2	53.5	100	53.4	90.3	37.8	23.5	13.5
Brazil	8.0	22.1	71.8	42.8	100	44.4	76.9	39.0	54.6	44.6
Chile	24.5	51.4	93.1	89.4	100	48.0	78.4	54.2	61.8	56.4
Colombia	16.6	65.0	113.1	96.3	100	49.9	41.2	29.0	31.2	33.3
Mexico	38.6	72.7	132.1	45.9	100	49.7	118.5	83.3	116.2	98.7
Peru	n.a.	n.a.	72.9	56.4	100	57.3	67.7	54.1	60.2	57.6
Venezuela	84.9	82.2	50.8	37.9	100	26.2	36.2	46.3	31.7	27.3
B. East Asia (6)	n.a.	49.9	110.0	97.9	100	37.0	107.9	45.1	77.0	73.9
Indonesia	n.a.	53.7	84.2	71.6	100	11.1	27.6	13.7	17.3	22.0
Korea	n.a.	87.6	187.2	161.9	100	30.2	120.1	54.9	109.6	111.9
Malaysia	n.a.	63.7	119.0	103.5	100	16.8	61.3	35.6	46.1	47.3
Philippines	n.a.	67.1	134.6	108.6	100	30.4	47.9	25.5	30.9	27.7
Taiwan	n.a.	37.1	80.9	73.5	100	47.6	99.1	31.6	55.5	48.8
Thailand	n.a.	133.9	279.8	236.3	100	19.0	48.0	25.2	36.1	42.2

Source: Based on IFC/Standard & Poor's, Emerging Stock Market Review, several issues. The averages of Latin America and of East Asia are weighted by amount of transactions. Values at the end of each period, expressed in current U.S. dollars; excluding distributed earnings. Selected dates correspond to peaks and minimum levels for the average of Latin America (except for September, 1992).

In what relates to domestic interest rates, particularly in LACs, they tended to be high at the outset of surge episodes, reflecting the binding external constraint (BEC) faced by most countries during periods of dryness in capital inflows, the restrictive monetary policies in place and the short-termist bias of the financial reforms implemented (see Ffrench-Davis, 2000, ch. 2). Finally, in a

non-exhaustive list, the increased supply of external financing in the 1990s generated a process of exchange-rate appreciation in most LACs as well as, more moderately, in East Asia; the expectation of continued appreciation encouraged additional inflows from dealers operating with maturity horizons located within the expected appreciation of the domestic currency.

The increased supply of external funding in three episodes (1977-1981; 1991-1994 and 1995-1997) generated, in itself, a greater demand for such financing, associated with procyclical domestic policies. Recipient countries that formally adopted procyclical policies or took a passive stance experienced real exchange revaluation, a boom in domestic credit, and large deficits on current account, which were often financed by short-term and liquid capital flows. As a consequence, they tended to become increasingly vulnerable to changes of mood by creditors; the outstanding cases are Mexico in 1991-1994 (Ros, 2001) and Argentina after the Asian crisis. Given their high exposure of financial assets placed in the region, creditors became more sensitive to “bad news”. The sensitiveness rose steeply with the size of net short-term liabilities (Rodrik and Velasco, 2000; Stiglitz, 2000).

In brief, the interaction between the two sets of factors —*the nature of agents and a process of adjustment*— explains the dynamics of capital flows over time. When creditors *discover* an emerging market, their initial exposure is negligible or non-existent. Then they generate a series of consecutive flows, which result in rapidly increasing stocks of financial assets in the emerging market. The creditor's sensitivity to negative news, at some point, is likely to, suddenly, increase remarkably when taking notice of the level of the stock of assets held in a country (or region), and with the degree of dependence of the debtor on additional flows, which is associated with the magnitude of the current account deficit, the refinancing of maturing liabilities and the amount of liquid liabilities likely to flow out of the country in face of a crisis. Therefore, it should not be surprising that, after a significant increase in asset prices and exchange-rates, accompanied by rising stocks of external liabilities, the probability of reversal of expectations about their future trend grows steeply.

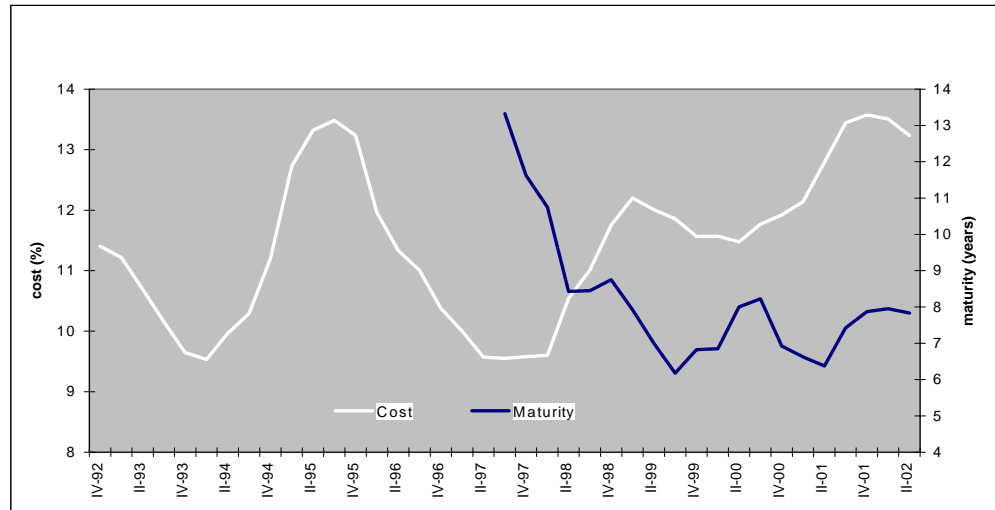
First, the accumulation of stocks and, then, a subsequent reversal of flows can *both* be considered to be *rational* responses on the part of individual suppliers, given the short-term horizon of the main agents on the supply side. This is because it is of little concern to investors with short horizons whether (long-term) fundamentals are being improved or worsened with capital surges while they continue to bring inflows. What is relevant to these investors is that the crucial indicators from their point of view —real estate, bond and stock prices, and exchange-rates— can continue providing them with profits in the near term and, obviously, that liquid markets allow them, if needed, to reverse decisions timely; thus, they will continue pouring-in money until expectations of an imminent near reversal start to build up. Indeed, for the most influential financial operators, the more relevant variables are not related to the long-term fundamentals but to short-term profitability. This explains why they may suddenly display a radical change of opinion about the economic situation of a country whose fundamentals, other than liquidity in foreign currency, remain rather unchanged during a shift from over-optimism to over-pessimism.

Naturally, the opposite process tends to take place when the debtor markets have adjusted downward “sufficiently”. Then, the inverse process makes its appearance and can be sustained, like in 1991-1994 or 1995-1997, or short-lived like in 1999-2000.⁶

It is no coincidence that, during all three significant surges of the last quarter century, loan spreads underwent a sustained fall while the stock of liabilities rose rapidly: for 5-6 years in the 1970s; 4 years before the Tequila crisis, and over a couple of years after that crisis (see figure 1).

⁶ Vulnerabilities were still significant in EEs when negative signals reappeared in the world economy, including the downward adjustment in the United States.

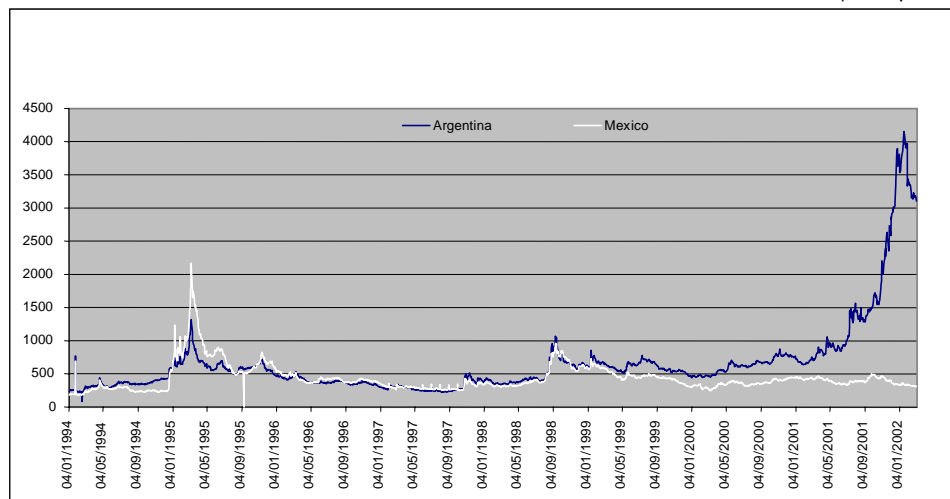
Figure 1
LATIN AMERICA: COST AND MATURITY OF ISSUES OF BONDS, 1992-2002
(Percentages and years)



Source: ECLAC, World Bank and IMF. Annual moving averages. The cost is equal to the average spread on issues of bonds plus the rate of return of U. S. Treasury 10 year bonds.

This implies, during the expansive side of the cycle, a sort of downward sloping medium-run supply curve, a highly destabilizing feature indeed. In this respect, it is interesting to observe the evident parallel between spreads of Mexico (today praised as a well-behaved reformer in the 1990s) and Argentina (today qualified as a non-reformer in the 1990s) (see figure 2). Apparently, creditors did not perceive any significant difference between these two economies until 1999.

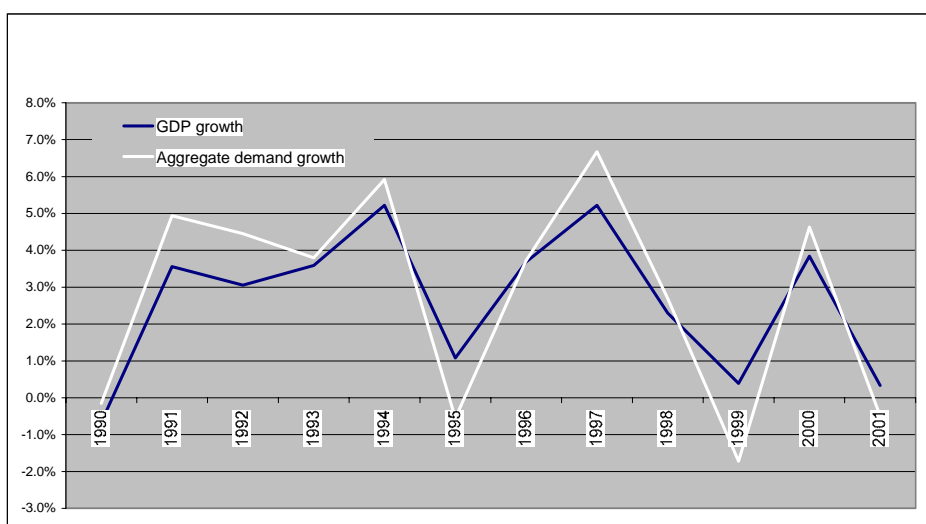
Figure 2
ARGENTINA AND MEXICO: COUNTRY RISK, 1994-2002
(Base points)



Source: J.P. Morgan. Country risk measured by the sovereign spread over the U. S. zero coupon curve.

One particularly relevant issue is that, as stressed in Ffrench-Davis (2000), economic agents specialized in the allocation of financial funding (I will call it microfinance, as opposed to macrofinance), who may be highly efficient in their field but operate with short-horizons “by training and by reward”, have come to play the leading role in determining macroeconomic conditions and policy design in EEs. This leads, unsurprisingly, to unsustainable macroeconomic imbalances, with “wrong” or outlier macroprices and ratios. In figure 3, we observe a notorious instability of GDP growth for the total of Latin America; obviously, that of individual countries tend to be even more unstable. The data shows that changes in GDP have been led by up-and-downs in aggregate demand. If we disaggregate changes in demand, we find that they were stronger in private expenditure, associated to the evolution of net capital inflows.

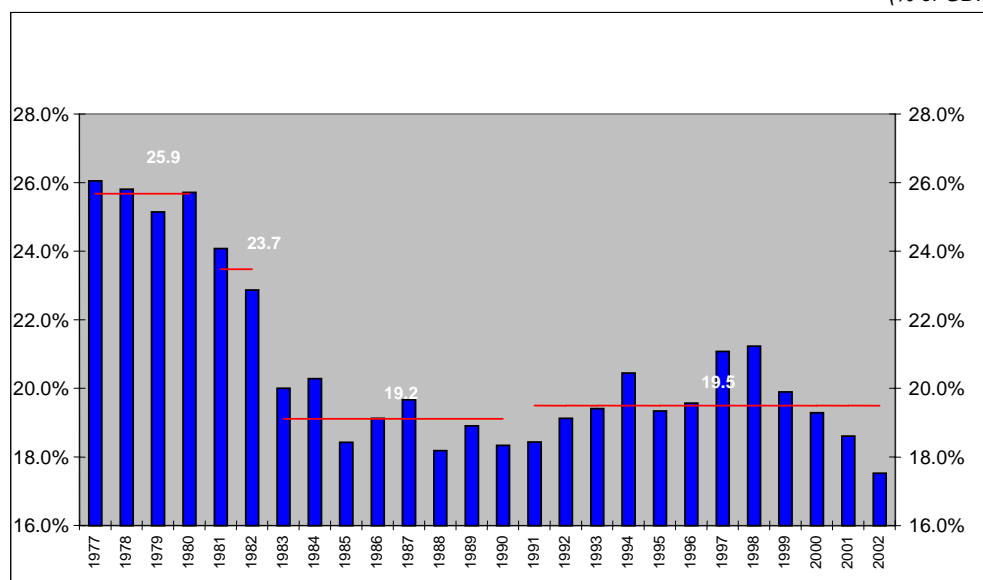
Figure 3
LATIN AMERICA (20): GDP AND AGGREGATE DEMAND, 1990-2001
(Annual growth rates, %)



Source: ECLAC, based on official figures in constant 1995 dollars.

The resulting real macroeconomic instability provides an undermined environment for productive investment. That is one strong force behind the poor achievement of investment ratios in the 1990s, when they surpassed by less than one percentage point of GDP the 1980s average (19%), but remained over five points below that in the 1970s (see figure 4). That is a significant variable explaining why GDP growth was 5.6% in the 1970s and merely 2.4% in 1990-2002 (see table 2).

Figure 4
LATIN AMERICA: GROSS FIXED INVESTMENT, 1977-2001
 (% of GDP)



Source: Based on ECLAC figures for 19 countries, scaled to 1995 prices. Preliminary data for 2002.

Table 2
LATIN AMERICA AND EAST ASIA: GROSS DOMESTIC PRODUCT, 1971-2002
 (Annual growth rates, %)

A. Latin America	1971-1980	1981-1989	1990	1991-1994	1995	1996-1997	1998-2002 ^a	1990-2002 ^a
Latin America (19)	5.6	1.3	-0.6	4.1	1.1	4.5	1.2	2.4
Argentina	2.8	-0.7	-2.0	8.0	-2.9	6.7	-3.3	1.7
Brazil	8.6	2.3	-4.6	2.8	4.2	2.8	1.7	1.9
Chile	2.5	3.0	3.3	7.5	9.0	6.8	2.3	5.2
Colombia	5.4	3.7	3.2	3.9	4.9	2.6	0.4	2.4
Mexico	6.7	1.5	5.1	3.5	-6.2	6.1	3.2	3.1
Peru	3.9	-0.7	-5.4	5.1	8.6	4.6	1.6	3.0
Venezuela	1.8	-1.5	5.5	3.2	5.9	3.4	-1.2	1.9

Source: ECLAC, expressed in U.S. dollars at 1980 prices for 1971-1980, at 1990 prices for 1980-1989, and at 1995 prices for 1989-2002.

^a Provisional figures.

B. East Asia	1971-1980	1981-1990	1991-1996	1997	1998	1999-2002	1990-2002 ^a
East Asia (6)^b	8.1	7.0	7.3	4.6	-5.4	4.7	5.3
Indonesia	7.7	5.5	7.8	4.7	-13.1	3.1	4.4
Korea	9.0	8.8	7.3	5.0	-6.7	7.1	6.1
Malaysia	7.8	5.2	9.5	7.3	-7.4	4.8	6.5
Philippines	5.9	1.7	2.7	5.2	-0.6	3.6	3.0
Taiwan	9.3	8.5	7.0	6.7	4.6	3.0	5.4
Thailand	7.9	7.9	8.1	-1.4	-10.8	3.5	4.6

Source: IMF, *International Financial Statistics*, and Asian Development Bank.

^a Provisional figures.

^b In each period, each country's GDP was weighted by its share in the regional output expressed in current US dollars.

Then, what is “irrational”, and evidently inefficient from the perspective of resource allocation and total factor productivity, is that the decisions of authorities, which should obviously be taken with a long-term horizon, become entrapped with the lobbying and policy recipes of microfinance experts, what leads to “irrational exuberance” (to use Greenspan’s expression). Thus, in the next cycle, macroeconomic authorities should undertake the responsibility of making fundamentals (sustainable external deficit; moderate stock of external liabilities, with a low liquid share; crowding-in of domestic savings; limited real exchange rate appreciation) prevail, in order to achieve macroeconomic balances that are both sustainable and functional for long-term growth. That requires them to avoid entering *vulnerability zones* during economic booms-cum-capital surges. When placed inside those zones, a much-needed counter-cyclical policy becomes impossible during the period of dryness, as discussed in the next section.

II. Domestic policies and a macroeconomics for growth

As discussed in Ocampo (in this volume), the association between capital flows and domestic economic activity has been an outstanding feature of the emerging market economies during the past quarter century. This fact highlights the central role played by the mechanism by which externally generated boom-bust cycles in capital markets are transmitted to the developing world, and the vulnerabilities they generate. The high costs generated by business cycles in EEs are thus related to the strong connections between domestic and international capital markets. This implies that an essential objective of macroeconomic policies is how to reap the benefits from external savings, but reducing the intensity of capital account cycles and their negative effects on domestic economic and social variables. Ocampo discusses two complementary policy instruments to achieve these objectives: capital account regulations and counter-cyclical prudential regulations of domestic financial intermediation.⁷

Capital account cycles are associated to the twin phenomena of volatility and contagion. Significant shifts in expectations, usually reinforced by subsequent risk-rating changes, lead to sharp procyclical changes in the availability of financing, maturities and spreads (see figure 1, above).⁸ The most damaging, as already argued, are the medium-term fluctuations rather than very short-term volatility:

⁷ Neither of them is a substitute for the risks that either pro-cyclical or "irresponsible" macroeconomic policies may generate.

⁸ The markets have made some progress towards stability by introducing countercyclical adjustment clauses of loans: for instance, tied to export prices (see Budnevich, in this volume) and collective action clauses (see Williamson, in this volume). On the other hand, risk-rating agencies continue to behave pro-cyclically and to follow rather than to lead the financial markets (see Reisen, in this volume).

several years of abundant financing (i.e. 1991-1994 and mid 1995 to 1997) followed by several years of dryness (1998-2002, with a brief upsurge around 2000).

Capital account regulations may perform as a prudential macroeconomic tool, working at the direct source of boom-bust cycles: unstable capital flows. If effective, they provide room to "lean against the wind" during periods of financial euphoria, through the adoption of a contractionary monetary policy and reduced appreciation pressures. If effective, they will also reduce or eliminate the quasi-fiscal costs of sterilized foreign exchange accumulation. What is extremely relevant, is that, in the other corner of the cycle, of subsequent binding external constraints, the domestic economy is left with space for expansionary —countercyclical— monetary and fiscal policies.

Capital account regulations also serve as a liability policy. The market rewards sound external debt structures, because, during times of uncertainty, the market responds to *gross* financing requirements, which means that the rollover of short-term liabilities is not financially neutral. This indicates that economic policy management during booms should seek to improve maturity structures, of both private and public sector liabilities.

Ocampo discusses recent innovations in capital account regulations. Overall innovative experiences in the 1990s of across-the board price restrictions on liquid and short-term financial inflows, indicate that they can provide useful instruments, both in terms of improving debt profiles and facilitating the adoption of counter-cyclical macroeconomic policies. The basic advantages of a price-based instrument applied to inflows, pioneered by Chile and Colombia, are its simplicity and implementation during the boom periods. The more quantitative-type Malaysian systems, geared intensively to outflows, have shown to have stronger short-term macroeconomic effects. Traditional exchange controls as in China and India, (for instance, prohibitions on short-term financial borrowing) may be superior if the objective of macroeconomic policy is to significantly reduce the domestic macroeconomic sensitivity to international capital flows.⁹

These direct, price-based or quantitative, regulations on capital flows can be partly substituted by prudential regulation and supervision on domestic financial institutions. The main problem with this option is that it does not take care of the external borrowing of non-financial agents and, actually, may encourage their borrowing abroad (a severe problem, for instance, in the crisis of Korea and Thailand). Accordingly, it needs to be supplemented with other disincentives to external borrowing by those firms, deterrents that may become cumbersome and extremely difficult to implement. They may include restrictions on the class of firms that can borrow abroad, restrictions on the terms of corporate debts that can be contracted, and tax provisions that raise the cost of direct borrowing in foreign markets. Price-based capital account regulations may thus be a superior alternative and much simpler to administer.

Prudential regulation and supervision should take into account not only microeconomic risks, but especially the macroeconomic risks associated to boom-bust cycles. In particular, counter-cyclical devices should be introduced into prudential regulation and supervision, involving a mix of: (i) forward-looking provisions for latent risks, made when the credit is granted, on the basis of the credit risks that are expected throughout the full business cycle (an approach adopted by the Spanish authorities); (ii) more discrete counter-cyclical prudential provisions decreed by the authority on the basis of objective criteria (e.g., the rate of growth of credit), (iii) counter-cyclical regulation on the prices used for assets given in guarantee, and (iv) capital adequacy requirements focussed on long-term solvency criteria rather than on cyclical performance.

Aside from macroeconomic implications, prudential regulations and supervision of the domestic financial systems are needed for the sake of transparency, honesty and microeconomic efficiency. The record was bad in many cases of liberalization of domestic finance, without the

⁹ See, for instance, Agosin and Ffrench-Davis (2001) and Le Fort and Lehmann (2000) on Chile, and Kaplan and Rodrik (2001) on Malaysia.

previous reform and strengthening of regulation and supervision. A severe banking crisis in Chile in 1983, costing the Treasury one-third of GDP, interestingly had been lost in the memory of financial reformers of the 1990s in Latin America; most bulky errors were replicated.

The financial crises of 1994-1995 and 1997-1998 sounded wake-up calls to Latin America and East Asia, respectively, indicating that regulation and supervision needed to be strengthened substantially. As reported by Stallings and Studart (in this volume), since then important steps have been taken to improve the rules and ensure their implementation, but financial regulation and supervision do not take place in a vacuum. Financial policies need a supportive consistent macroeconomic environment in which to operate, as the Argentine crisis of 2001-2002 shows only too well.

Problems of individual banks can set off chain reactions, both because of the direct links between banks, and because of the effects that bank collapses may have on borrowers' capacity to honor commitments. Moving from systems where authorities set interest rates, directed credit, and held a large share of bank deposits as required reserves, governments freed commercial banks to make their own decisions on borrowers, loan volume, and prices. At approximately the same time, both in LACs and East Asia, capital account liberalization enabled local banks to engage in transactions in foreign currencies and allowed foreign institutions to enter local markets. The lack of an adequate regulatory and supervisory system, in parallel, compounded problems for bankers without sufficient experience in credit analysis of local borrowers, understanding of financial mismatches, and the complexities of international financial markets.

The typical results were credit booms, maturities and currencies mismatches, and eventually banking crises. As seen in the paradigmatic Chilean case (but also later in Mexico, East Asia, and Argentina), the errors by domestic actors themselves could provide the basis for such crises; if combined with external shocks, the situation becomes far more severe (Ffrench-Davis, 2002, ch. VI). Government rescues tended to follow a standard package. In the first instance, they involved takeover of non-performing loans, recapitalization of banks, and liquidations and mergers, usually involving foreign institutions.¹⁰ Later, in an attempt to prevent future crises, regulation and supervision were stepped up; greater information and transparency were required. Stallings and Studart, on the basis of World Bank data bank (see Barth, Caprio and Levine, 2001), revise the recent situation in Latin America, particularly in Argentina, Brazil, Chile and Mexico.

According to the authors, these countries have advanced quite considerably in restructuring their financial system and putting in place prudential regulation and supervision, after the initial phase of more naïve financial liberalization. Supposedly, with the reform to the previous reform, these countries had become better able to withstand external shocks, with their financial systems showing greater resilience than before. It was a common belief within IFIs that Argentina had progressed enormously in terms of improving its financial system. This is a confirmation that Argentina, as evaluated by financial markets, classified as a well-behaved and dedicated reformer.

The authors, based on the World Bank data, find that Argentine regulations appeared to be the strictest in the region. It is clear, however, that very strong macroeconomic shocks can undermine even the strictest regulations and lead to banking crises, as the Argentine situation in 2001-2002 shows. In this case, a particularly crucial domestic variable was an outlier macro-price, the exchange rate, in a highly but far from fully dollarized economy. A sharp rise in spreads faced by Argentina complicated, severely, her fiscal stance.

¹⁰ There have been sizable acquisitions in the banking activity of EEs, particularly in Central Europe and Latin America. For instance, in Argentina half of banks assets belonged in 2000 to foreign controlled banks. Interestingly, foreign ownership has implied that offshore lending by those banks has converted to onshore lending (see papers by Hawkins and by Lubin, in this volume). The conventional argument that the local presence of foreign banks would assist EEs in facing financial shocks, apparently, has not been supported in Argentina.

The exchange-rate regime has become a much more influential variable in EES, both on trade and finance. It is subject to two conflicting demands, which reflect the more limited degrees of freedom that authorities face in a world of reduced policy effectiveness (see Ocampo, 2002b; ECLAC, 2000). The first demand comes from trade: with the dismantling of traditional trade policies, the real exchange rate has become a key determinant of international competitiveness and a crucial variable for an efficient allocation of resources into tradables. The second is from the capital account. Boom-bust cycles in international financial markets generate a demand for flexible macroeconomic variables to absorb, in the short run, the positive and negative shocks generated during the cycle. Given the reduced effectiveness of traditional policy instruments, particularly of monetary policy, the exchange rate can play an essential role in helping to absorb shocks. This objective cannot be easily reconciled with the trade-related goals of exchange-rate policy.

The relevance of this dual demand is ignored in the call to limit alternatives to the two extreme exchange rate regimes, either a totally flexible exchange-rate or a currency board (or outright dollarization). Intermediate regimes, of managed exchange-rate flexibility—such as crawling pegs and bands, and dirty floating—, attempt to reconcile these conflicting demands (see Ffrench-Davis and Ocampo, 2001; Ocampo, 2002b; Frankel, 1999; Williamson, 2000).

As argued by Ffrench-Davis and Larraín (in this volume), completely rigid exchange rate systems tend to amplify external shocks, because they put too strong and unrealistic requirements on domestic flexibility, in particular on wage and price flexibility in the face of negative shocks. Currency boards certainly introduce built-in institutional arrangements that provide for fiscal and monetary discipline, but they reduce radically any room for stabilizing monetary, credit and fiscal policies, which are all necessary to prevent crises and facilitate recovery in a post-crisis environment. They thus allow the domestic transmission of external shocks, generating strong swings in economic activity and asset prices, with the corresponding domestic financial vulnerability. There is an amplification effect when agents consider that an external shock that is strong enough can induce authorities to modify exchange rate policy; this is particularly so when the rate appears to be an outlier price, too appreciated.

Notwithstanding the pitfalls of the family of nominal pegs, there are particular cases in which it can work efficiently. The currency board in Argentina, assisted by the capital surge to LACs since the early 1990s, was quite effective in stopping hyperinflation, evidently the more harmful problem of that economy in 1991. Subsequently, however, it was a severe mistake not to use the opportunity provided, in 1992 or 1993, to flexibilize the rate when inflation and the budget were evidently under control, capital inflows were vigorous and spreads to EEs, quite explicitly including Argentina, were falling.

On the other hand, the volatility characteristic of freely floating exchange-rate regimes is not a problem when market fluctuations are short-lived; they are easily faced with derivatives (see Dodd, in this volume). But fluctuations become a major concern when there are longer waves, in a lasting process, as has been typical of the access of EEs to capital markets in recent decades. In this case, volatility of that macro-price tends to generate perverse effects on resource allocation in irreversible capital formation. Moreover, under freely floating regimes with open capital accounts, anti-cyclical monetary policy exacerbates cyclical exchange-rate fluctuations, with their associated allocative and income effects.

The ability of a flexible exchange-rate regime to smooth out the effects of externally-induced boom-bust cycles thus depends on the capacity to effectively manage a counter-cyclical monetary and credit policy without enhancing pro-cyclical exchange-rate patterns. The feasibility and effectiveness are strengthened under intermediate exchange-rate regimes *cum* capital account regulations. That was, clearly, the case of Chile in the first half of the 1990s (see Ffrench-Davis, 2002, ch. 10; Le Fort and Lehmann, 2000).

However, as discussed by Ffrench-Davis and Larraín, bands did not behave well during the Asian crisis. In many cases, that was partially induced by the actual management of the band. The huge increase in capital inflows to emerging economies, that took place between 1990 and 1997, did put severe upward pressure on exchange rates. The response, in terms of expanding the size of the band or appreciating it, induced a credibility loss. Subsequently, bands already with a too appreciated rate, had trouble in adapting to the sharp shift brought by the Asian crisis, when capital inflows suddenly stopped. These facts aggravated the mismanagement of bands, and therefore induced a further credibility loss.

The major benefit of managed flexibility, including bands, arises in times without severe shocks. In that case, bands induce more real exchange rate stability, keeping the ability to partially absorb the effects of moderate shocks. Consequently, the exchange rate fulfils more efficiently its allocative role between tradables and non-tradables.

Obviously, intermediate regimes may also generate costs and shortcomings (see Ocampo, 2002b). First, intermediate regimes are subject to speculative pressures if they do not generate credibility in markets, and the costs of defending the exchange-rate from pressures under these conditions are very high. Second, sterilized reserve accumulation during long booms may become financially costly. Lastly, the capital account regulations needed to manage intermediate regimes efficiently are only partially effective. But, all things considered, intermediate regimes offer a sound alternative to costly volatility.

Ffrench-Davis and Larraín, in their review of the Argentinean, Chilean and Mexican experiences, show that a policy suitable for a given macroeconomic environment may not be so in another. In this sense, one crucial element to bear in mind when adopting a given policy is how costly it may be to switch to an alternative policy.

Credible pegged systems may be useful when a crisis, with hyperinflation, has bottomed, and there is plentiful supply of external funding. Floating systems are useful in times of financial distress, when authorities have doubts concerning the level of the real rate, or the nature of the shock they face; flotation allows them not to put in jeopardy their reputation defending the wrong real exchange rate.

Finally, bands contribute to stabilize the real exchange rate. Stability in the real exchange rate has a positive effect on the quality of exports and on growth (see ECLAC, 1998a, ch. IV). But bands suffer a weakness if a "big shock" appears and authorities fail to have avoided vulnerability zones during the previous boom. In that case, they open the way to speculation, inducing significant financial instability, which can be faced, more efficiently, moving temporarily to a fully flexible rate.

Ffrench-Davis and Larraín summarize why corner solutions do not have symmetric consequences. With a capital surge, the current account deteriorates, asset prices increase and the real exchange rate appreciates. Each exchange rate policy will deliver different combinations of those three elements. With pegged systems, a capital surge creates a demand boom, pulling-up asset prices, probably with a crowding-out of domestic savings and a worsening of the external balance. With floating regimes, a nominal appreciation will take place making the process of real appreciation faster (and henceforth potentially more disruptive) than with the peg. Pegs tend to work better in the upward phase of the cycle, but after the inflection point the float does it better in terms of the necessary expenditure switching. But, in this type of cycle there is the possibility of multiple equilibria based on self fulfilling beliefs: expectations of more inflows (outflows) may further appreciate (depreciate) an already appreciated (depreciated) currency.

Large deviations from equilibrium of the real exchange rate are costly. Central Banks should be concerned with both the level and the stability of the exchange rate. In this sense, despite what has happened since the Asian crisis, managed flexibility, with or without bands, is still a policy to

be considered by policy-makers. They need to be careful with across-the-board liberalization of the capital account, as the behavior of capital flows may tend to be inconsistent with macroeconomic stability, particularly in terms of the stability of the exchange rate and economic activity. In this sense, authorities need to have flexible policy packages rather than single rigid policy tools.

Fiscal policy ought to be part of the flexible policy package. As discussed by Budnevich (in this volume), fiscal policy has two macroeconomic objectives, the sustainability of public accounts and the regulation of aggregate demand. It is evident that policy efforts have concentrated on the first objective, leaving the stabilizing role to monetary policy.

Given the vulnerability of EEs to global economic downturns, over reliance on monetary policy may bring poorer macro results, as compared to a more balanced framework of counter-cyclical fiscal, exchange rate, and monetary policy, as well as prudential regulation of capital flows. The use of counter-cyclical fiscal policy requires as a precondition to have solvent and sustainable fiscal accounts. Additionally, a more active role of counter-cyclical fiscal policy may emerge when transmission channels of monetary policy to the output gap are weak or show significant lags. Moreover, to spread the adjustment burden between fiscal and monetary policy may bring better macroeconomic results, with macroprices closer to sustainable equilibria.

Fiscal policy has been at the core of the debate on adjustment programs in EEs (see ECLAC, 1998b; Ocampo, 2002b). Both in East Asia and Latin America the more conventional recipes recommended achieving current or annual fiscal balances, when in recessionary conjunctures, which depressed tax proceeds. That is a typically procyclical behavior. In Latin America, fiscal policy has not played a relevant counter cyclical role. In recession, fiscal policy has been typically directed towards keeping under control financial solvency, while during booms expenditure tends to expand with the cycle.

As part of a counter-cyclical policy package, the concept of structural balance is the most outstanding fiscal component. There are different definitions, but the essential component is the measurement of the balance across the business cycle, estimating at each point of time what would be the public expenditure and income in a framework of sustainable full employment of human and physical capital. If the terms of trade fluctuations are relevant for tax proceeds—via profits of public or private exporters—the purchasing power of potential GDP should be estimated at the trend terms of trade as well as public income. Chile has advanced effectively in the implementation of a structural fiscal balance (see Tapia, 2003).

Developing countries typically concentrate their international trade on a few commodity exports, which are subject to highly volatile market prices. Especially, when a significant export—like copper in Chile, and oil in Colombia, Mexico or Venezuela—is public property, the establishment of a stabilization fund can contribute to macroeconomic sustainability. Also the coffee fund in Colombia has played, for long, a significant stabilizing macroeconomic role. Above the trend or "normal" public proceeds from that source are saved in the fund, so to finance public expenditure when proceeds are below "normal".

As argued by Budnevich, most commodity prices tend to revert eventually to their trend—a requirement for a stabilization fund to be viable—but only very slowly with an average reversal time measured in years. Thus, a commodity stabilization fund has to be very large to be effective in the long-run. Furthermore, in the case of an export stabilization fund, it is highly recommended to initiate it in a scenario of high prices in comparison to trend prices, so that the fund could actually finance subsequent negative price scenarios.

The same principle of stabilization funds can be used for deviations in tax proceeds from their structural level. Flexible tax rates have been proposed as a further counter-cyclical device. Proposals tend to concentrate in VAT and contributions to pension funds. For instance, when the external deficit is above a "sustainable" level, because of excess domestic absorption, then the

proceeds of the value added tax (VAT) will exceed the structural level. That excess could be automatically saved in the fund. That would contribute to push aggregate demand downward towards equilibrium. The disadvantage of the VAT (inflationary impulse in the short-run, when tax rates are increased) must be weighted against the advantages (broad tax base and effects on consumption rather than investment). VAT adjustments will not bring significant misallocations of resources and are collected frequently. However, it is likely to involve some transaction costs. Another potential policy tool to consider is to allow some short-term variation in compulsory pension fund or unemployment insurance contributions. The existence of effective and significant unemployment insurance itself is both a socially desirable as well as an important counter-cyclical stabilizer. Of course, the most direct tool is the regulation of flows when they are the source of disequilibria.

III. Some policy lessons and pending issues

A growing body of literature documents that a dominant feature of the "new generation" of business cycles in EEs are the sharp fluctuations in private spending and balance sheets associated to boom-bust cycles in external financing. Of course, external shocks, both positive and negative, will be multiplied domestically if the exchange rate, fiscal and monetary policies stance are also pro-cyclical, as it is actually expected to be by financial market agents and even by multilateral agencies (particularly the IMF). Changes in expectations and credibility in domestic macroeconomic authorities and domestic financial intermediaries play a key role throughout the process.

As a consequence, we have observed that EEs have penetrated in vulnerability zones, including (i) high external liabilities, with a large liquid share, (ii) high current external deficits, (iii) high (appreciated) exchange rates, and (iv) high prices of domestic financial assets and real estate.

A. Policy lessons

In a previous occasion we have summarized what we consider robust policy lessons (see Ffrench-Davis and Ocampo, 2001). We have grouped them into five areas of action:

- (i) Maintain a sustainable volume and composition of external liabilities, and of capital flows; sustainability is closely related to the use made of inflows.

- (ii) Avoid outlier exchange rates, and price/earnings ratios of equity stock.
- (iii) Adopt a flexible comprehensive prudential macroeconomic regulation, including the financial system, fiscal accounts and capital flows.
- (iv) Search for a reform of the international financial architecture, required for a more efficient and balanced globalization.
- (v) Focus on crisis-prevention policy, based on the prudential management of booms.

But, if these lessons have not been learned, and the country or region is in a critical conjuncture as it is today in Latin America, what are the policy recommendations to find an answer to the pending issues?

B. Pending issues

In the domestic dimension, there are three issues we want to consider. The quality of recovery, capital account opening and the sustainability of real macroeconomic equilibria, and the constituencies served by authorities.

First, the quality of recovery; again, here, the approach taken in the pre-crisis stage is crucial. Countries which have undergone severe crises—including Korea, where recovery was very strong—usually display evidence that they are pushed into a lower GDP path. There are three particularly relevant medium-term effects on GDP. One is a sharp reduction of productive investment that occurs during the crisis, which naturally deteriorates the path of potential GDP; second, the worsening of balance sheets (Krugman, 1999), as shown by the experience of EEs, indicates that restoring a viable financial system takes several years, generating adverse effects throughout the period in which it is rebuilt; third, a growing body of evidence that boom-bust cycles have ratchet effects on social variables (Rodrik, 2001). The deterioration of the labor market (through open unemployment, a worsening in the quality of jobs or in real wages) is generally very rapid, whereas the recovery is painfully slow and incomplete. This is reflected in the long-lasting worsening of real wages in Mexico after the Tequila crisis (Ros, 2001).

These three problems signal policy priorities during the crisis: sustaining public investment, encouraging private investment; contributing to reschedule liabilities, and assisting in solving currency and maturity mismatches; reinforcing a social network, that uses the opportunity to improve the productivity of temporarily underutilized factors.

A second issue is that, commonly, it is argued that fully opening the capital account discourages domestic macroeconomic mismanagement. This is partly true for *domestic* sources of instability, i.e., large fiscal deficits, permissive monetary policy, and arbitrary exchange-rate overvaluation. However, the volatility in market perceptions makes this type of control highly unreliable in EEs with "responsible" authorities: lax demand policies or exchange-rate appreciation tends to be encouraged by financial markets during booms, whereas excessive punishment during crises may actually force authorities to adopt overly contractionary policies ("irrational overkill"). As we have argued, this is associated with the nature of the agents and the nature of the cycles. Indeed, market actors, such as credit rating agencies and investment banks, usually operate in a procyclical fashion (see, in relation to rating agencies, Reisen, in this volume).

Actually, the opening of the capital account may lead to a worsening in economic fundamentals. Thus, although market discipline can serve as a check to *domestic* sources of macroeconomic instability, it certainly becomes a *source* of externally-generated instability. The market may actually induce deviations of fundamental variables from sustainable levels, entering into *vulnerability zones*. Financial operators, perhaps unwittingly, they have come to play a role that has significant macroeconomic implications. With their herd-prone expectations, they have

contributed to intensify the financial flows towards “successful” countries during capital surges, thus facilitating rapid increases in the prices of financial assets and real estate, and sharp exchange-rate appreciation in the recipient markets. Apart from the poor quality of prudential regulation and supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, misleadingly, to be efficient and sustainable (with good profits and loan guarantees, supported by high stock prices and low value in domestic currency of dollar-denominated debt). But, in fact, bubbles are being generated with outlier macroprices, which sooner or later will tend to burst. Excessive indebtedness and periods of massive outflows ensue, prompting admonishment, in many cases, by the very agents who praised the economic performance of the EEs during the boom.

It is noteworthy that there is a broad consensus that “fundamentals” are a most relevant variable. However, there is wide misunderstanding about what constitutes “sound fundamentals”, and how to achieve and sustain them. A comprehensive definition of fundamentals should include - alongside low inflation, sound fiscal balance and dynamic exports-, sustainable external deficits and net debts, low net liquid liabilities, non-outlier real exchange rate, a crowding-in of domestic savings, sustained high and efficient investment in human and physical capital, strong prudential regulation and supervision, and transparency of the financial system. In recessive periods it should imply, for instance, (i) the implementation of a structural fiscal balance (recognizing that during recession tax proceeds are abnormally low and that, in those circumstances, public expenditure should not follow taxes in their descending runaway), and (ii) a strong encouragement to effective demand, with switching policies when domestic activity is clearly below productive capacity (see Ffrench-Davis, 2000, ch. 6).

Third, there is a growing duality, worrisome for democracy, in the constituencies taken into account by authorities. The increasing complexity and globalization of the economic system is raising the distance between decision-makers, financial agents and the agents (workers and firms) bearing the consequences. A consequence of the specific road taken by globalization has been that experts in financial intermediation —a microeconomic training— have become determinant for the evolution of the countries' macroeconomy. However, a good economic system needs to move in a quite different direction; that is, to reward productivity improvements more than speculation, and “rent-seeking”.

The integration of capital markets has remarkable implications on the governance of domestic policies and on the constituencies of national governments. In fact, most leaders in emerging countries are living a *'dual constituency syndrome'* (Pietrobelli and Zamagni, 2000): on the one hand they are elected by their countries' voters, but on the other hand they also seek the support of those who “vote” for their financial investments. Recent cycles in financial markets have revealed a significant contradiction between the two, in a negative sum game. A positive outcome requires institutions and policies actively achieving consistency between the level and composition of financial flows and real macroeconomic sustainability.

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