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# **Macroeconomics for development: from “financierism” to “productivism”**

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**C**ontrary to the belief that the region has found its way to an efficient macroeconomic policy, this paper argues that macroeconomic failures have been partly responsible for its disappointing economic and social performance in recent decades. Producers of GDP have had to cope with extremely unstable demand, exchange rates and access to financing, which have discouraged productivity and investment. Financial capital flows have been a determinant of this macroeconomic instability. This paper examines their intrinsically procyclical behaviour and concludes that an environment friendly to production development requires countercyclical regulation of financial flows. It describes how regulation of aggregate demand needs to be reconciled with the evolution of potential GDP, the real exchange rate with the current account, and financial flows with a far-reaching reform of the capital market reforms, away from “financierism” and towards “productivism”.

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# I

## Introduction

The countries of Latin America have introduced deep economic reforms in the context of what came to be known as the Washington Consensus, including far-reaching trade and financial liberalization, privatization and a new fiscal discipline, in the belief that this would be enough to ensure stability, economic growth and increased well-being. The reality is that price stability has been achieved (inflation generally under control) over the past two decades, but with low average gross domestic product (GDP) growth and a high degree of instability in the real economy, i.e., in output and employment.

It is often argued that the region has learned to cope effectively with the macroeconomic challenge and that its failures are microeconomic. However, the fact is that production and employment have been affected by large cyclical swings in economic activity, overall demand, credit access and exchange rates. These are key macroeconomic variables, forming the environment in which producers of goods and services operate. This article will analyse how the volatility of these macroeconomic variables has discouraged capital formation, employment and actual productivity. Financial capital flows have played a central role here.

Notwithstanding the diversity of the Latin American countries, the direction of fluctuations in economic activity, aggregate demand, real exchange rates, saving rates, investment and capital flows have coincided to a great extent. The synchronicity is particularly marked among the majority of large and medium-sized countries, with less-developed countries showing substantial differences.

The macroeconomic environment is mainly the outcome of the effects and interrelationships of fiscal, monetary and exchange-rate policies, domestic capital markets and the capital account. In turn, this environment influences the speed and

stability of economic growth and the distribution of its benefits, chiefly through its effects on capital formation and employment. Contrary to what tends to be implied by the traditionally very high degree of compartmentalization between micro- and macroeconomic analyses, the fact is that poverty reduction efforts, the degree of equity in a society and economic growth are strongly affected by the quality of the macroeconomic environment.

The emergence of the global crisis, for all its severe recessionary and regressive effects, has had a salutary result insofar as it has buttressed arguments for the central importance of macroeconomic policymaking styles and the need to consider ways of correcting current practices (see, for example, Blanchard, Dell’Ariccia and Mauro, 2010). This is essential in a development strategy designed to achieve growth with equity.

The core argument of this article is that there is a need to move from the strong “financierist” and “short-termist” bias that prevails at present to an approach that explicitly prioritizes productive development and its effects on equity. This requires an integrated approach incorporating the interrelationships between the micro- and macroeconomy and taking account of the implications of profound structural heterogeneity in national markets and the intrinsically procyclical nature of international financial flows. One aspect of this is that the instabilities referred to have very different effects on large and small firms, on investment and consumption, and on skilled and unskilled workers. The gradualism of policies and the quality of coordination between their monetary, exchange-rate, financial and fiscal aspects, for example, make a great difference to economic growth and its distributional effects, and particularly the quality of employment.

Interrelationships encompass static and dynamic effects. An example of the former are the effects on the utilization rate of the productive capacity of labour and capital. Fluctuations in this rate have repeatedly opened up large gaps between installed capacity or potential GDP and the GDP actually generated. These gaps, and the volatility of variables such as the real exchange rate, have had far-reaching dynamic effects on, for example, the investment ratio and its influence

□ I have written a number of texts on macroeconomic policy styles in emerging economies since an article published in *CEPAL Review* No. 60 (1996). The subject is explored further in Ffrench-Davis (2006) and (2008), plus versions produced for different events and publications. Here I try to summarize what I have learned about the subject. I am grateful for the assistance of Rodrigo Heresi and Felipe Labrin.

on the trend of development; the amount of value added to exports and their interrelationship with other components of GDP; innovation; the development of small and medium-sized enterprises; and formality or lack of it in the labour market. Macroeconomic policymaking styles have a considerable influence on all these variables and have been a crucial factor in the very modest 3.2% annual growth rate of regional GDP between 1990 and 2008.<sup>1</sup>

Consequently, while safeguarding the progress made with inflation control and fiscal discipline, there is a need to progress towards the creation of a macroeconomic environment that is more “friendly” to the different agents generating GDP. Section II summarizes the achievements and failures of the countries of Latin America as a group since 1990. The variables on which the analysis is focused exhibit effects that to a great degree are common to the majority of the population, despite the manifest differences between countries. Successes with inflation control, fiscal discipline and export dynamism are highlighted. There follows an exposition of how these successes have been accompanied by weak economic growth and very low levels of capital formation. Section III documents the great instability of aggregate demand and exchange rates with which the different agents have had to cope and the way this has been associated with recurrent external shocks

in financial capital flows and, more recently, to the terms of trade as well.

Section IV examines the characteristics of financial flows and addresses the issue of why these tend to be intrinsically procyclical in emerging economies. Section V considers the effects of instability, in particular with respect to the emergence of recessive gaps between potential output or the production frontier and actual GDP. This is followed by an analysis of how these gaps adversely affect firms’ balance sheets and expectations, along with employment. It is shown that the main impact of instability in economic activity over these years has been on the underutilization of production capacity for the domestic market. This is the part of GDP (non-exported GDP) that is most dependent on the domestic macroeconomic environment, which is what this article is about. Then comes an examination of the dynamic consequences of the region’s frequent recessions, manifested in falling ratios of productive investment and a deteriorating employment situation.

Section VI presents policy lessons for a development macroeconomics approach with a view to making the transition from “financierism” to “productivism”, the aim being to contribute more effectively to growth with equity. It focuses on fiscal, monetary, exchange-rate, domestic finance and capital account policies. Section VII concludes.

## II

### **Deep economic reforms and poor economic growth since the 1990s**

During the gestation of the so-called Washington Consensus, inflation was an extremely serious problem in a number of the region’s countries. Consequently, the reformers of the 1990s gave priority to combating it and imposing fiscal discipline. As one ingredient of this, they sought to insulate monetary management against pressure from governments running budget deficits. This entailed a tendency whereby central banks came to operate monetary and exchange-rate policies

independently of other areas of macroeconomic policy, with their actions confined to controlling inflation as a “primary if not exclusive” goal (Blanchard, Dell’Ariccia and Mauro, 2010, p. 3).

By the mid-1990s, inflation was under control; since 1997, average annual rates have been in single digits. Control of inflation was naturally associated with substantial improvements to fiscal balances and their financing. With these two important achievements and the abandonment of public-sector intervention in the region’s markets, the approach in fashion assumed that economic growth would arise spontaneously (see World Bank, 1997; IDB, 1997; Fischer, 1993). In parallel with macroeconomic achievements, far-reaching

<sup>1</sup> Ffrench-Davis (2006) examines the reforms and their effects. See also IDB (1997), World Bank (1997), ECLAC (1998 and 2000), Williamson (2003), World Bank (2005, in an interesting self-critical reaction), Rodrik (2006) and Ocampo (2008).

liberalization of imports (as one main stimulus for exports), domestic financial markets and the capital account was expected to play a strategic role as a driver of development.

It is clear that, with variations and to differing degrees, most of the countries of Latin America met these requirements of neoliberal macroeconomic balance as laid down by the Washington Consensus. Even the performance of export volumes was satisfactory as they expanded vigorously, growing at a rate one third faster than world trade.

Nonetheless, the results in terms of economic growth and equity have been poor. As table 1 shows, annual GDP growth (which includes production of exportables and non-exportables) averaged just 3.2% between 1990 and 2008, a far lower rate than East Asia's and similar to that of the United States, whose per capita income is four times as high as the region's. These averages include the catch-up of the post-2003 boom; GDP growth averaged 5.4% in the five years from 2004 to 2008, a figure not seen since the 1970s. As the boom came to an abrupt halt in 2009, with actual output and employment falling because of the

global crisis, the calculation ends in 2008 so that the evaluation and the quantitative data underlying it can be focused on more structural aspects.<sup>2</sup>

The data on GDP variability and the negative effects caused by it show that a macroeconomic approach focusing on the two pillars referred to (low inflation and fiscal discipline) proved unsatisfactory from the perspective of stability in the real economy, which is where GDP is generated. In fact, sharp fluctuations are observed in the GDP growth rate. These fluctuations, which affected the great majority of Latin Americans, were due not to sudden structural or microeconomic changes but to major swings in aggregate demand and the exchange rate (which affects its composition), and in the expectations or mood of economic actors. All of these are macroeconomic variables.

The greatest determinant of these macroeconomic changes, which generated recessive gaps between

TABLE 1

**Latin America (19 countries): GDP growth rates, 1971-2009**  
(Annual percentage averages)

	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1990-2008	2009
Argentina	2.8	-1.0	5.0	-1.3	8.4	4.0	0.9
Brazil	8.6	2.3	2.0	1.5	4.7	2.6	-0.2
Chile	2.5	2.8	7.0	2.7	4.9	5.4	-1.5
Colombia	5.4	3.7	3.9	1.1	5.5	3.6	0.8
Mexico	6.5	1.4	3.1	2.9	3.5	3.1	-6.5
Peru	3.9	-0.7	3.9	2.0	7.6	4.4	0.9
Uruguay	2.7	0.4	3.9	-2.1	8.3	3.2	2.9
Venezuela (Bolivarian Republic of)	1.8	-0.3	3.8	-2.7	10.3	3.5	-3.3
<b>Latin America (19)</b>							
Total GDP	5.6	1.3	3.3	1.4	5.4	3.2	-1.9
GDP per worker	1.7	-1.5	0.6	-1.1	3.0	0.6	-3.8
<b>Per capita GDP</b>							
Latin America (19)	3.0	-0.8	1.5	-0.2	4.0	1.7	-2.9
Asia (6)	4.9	5.0	5.6	2.0	3.5	3.9	-1.0
United States	2.2	2.4	1.6	2.1	1.4	1.7	-3.3
World	1.9	1.4	1.2	1.3	2.2	1.5	-3.2

Source: prepared on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC), World Bank and International Monetary Fund (IMF). Figures for 2009 are provisional.

Note: Asia (6) includes the Republic of Korea, Indonesia, Malaysia, Philippines, Thailand and Taiwan province of China, excepting 1971-1980 for the last of these.

GDP: gross domestic product.

potential and actual GDP over much of the 1990-2009 period, have been cyclical variations in capital inflows and outflows.<sup>3</sup>

The low figures for growth indicate that the per capita GDP gap between the region and the developed countries has remained very high. The data available for 2008 show that per capita GDP in Latin America stood at just 27% of the level enjoyed by the inhabitants of the Group of Seven (G-7) and 23% of that of the United States. In addition, an enormous social gap remains, as the ratio between the tenth and first

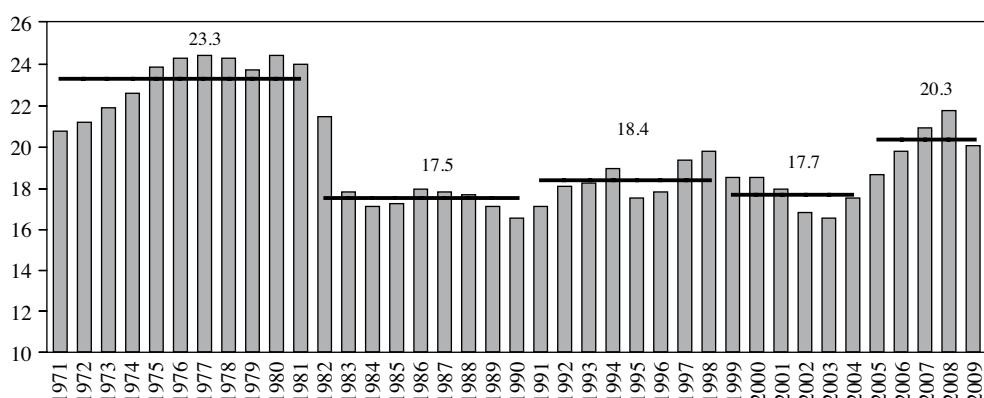
income deciles in the Latin American countries is almost treble that of the G-7 (a multiple of 34 as opposed to 12).

The dynamism of GDP depends on a number of factors, a very important one being the investment ratio. Spending on equipment and machinery, commercial and residential construction and infrastructure, which constitute gross fixed capital formation (GFCF), is closely associated with the macroeconomic environment that productive investors face and anticipate for the future. It transpires that the capital formation ratio has been remarkably low (see figure 1), compared both to that of successful emerging economies and to what the region itself achieved in the 1970s. In 1990-2008, the GFCF ratio averaged 18.5% of GDP, as against 23.3% in the 1970s.

<sup>3</sup> The resulting macroeconomic instability is not only recessionary and growth-depressing, but also has a markedly regressive bias (ECLAC, 2010; Ffrench-Davis, 2010b).

FIGURE 1

**Latin America: gross fixed capital formation, 1971-2009**  
(Percentages of GDP)



Source: based on data from the Economic Commission for Latin America and the Caribbean (ECLAC).

Note: In 2000 prices. Figures for 2009 are preliminary. The figures above the horizontal lines are annual averages for the respective periods.

GDP: gross domestic product.

### III

## Price stability versus instability in the real economy

The performance of the Latin American countries has been shaped by a macroeconomic environment in which the main actors—businesses, workers, investors and the State—have had to cope with considerable fluctuations in aggregate (or domestic) demand, economic activity and macroeconomic prices (ECLAC, 2000, chapter 6; ECLAC, 2010, chapter II; Ffrench-Davis, 2006, chapters I and II). Figure 2 tellingly illustrates the “rollercoaster” behaviour of aggregate demand.

In these two decades of Washington Consensus reforms, the macroeconomy has been a determining factor in the volatile and unsatisfactory performance of regional output. It can be seen that fluctuations in demand are quickly followed by fluctuations in GDP; by definition, this involves fluctuations in the utilization rate of available capital and labour. If the economy were in macroeconomic balance, meaning that there was no substantial “recessive gap” between

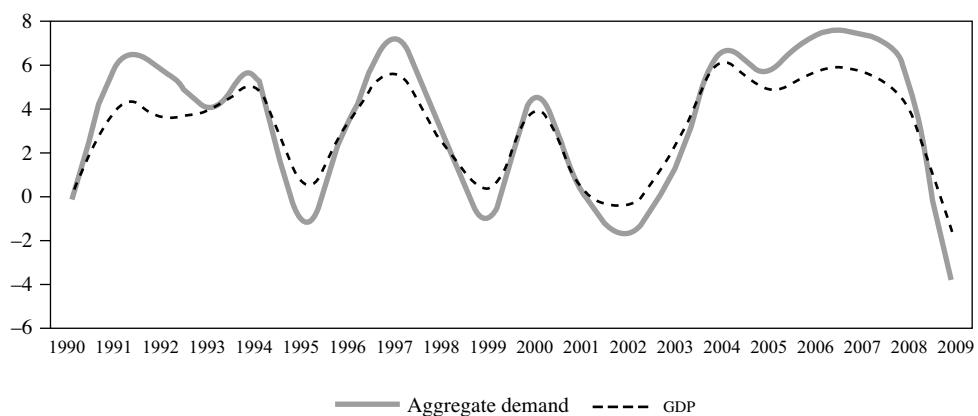
potential GDP ( $GDP^*$ ) and actual GDP ( $GDPa$ ),<sup>4</sup> strong and persistent growth in domestic demand (like that recorded during the 1990-1994, 1996-1997 and 2004-2007 periods) would have been followed by a fairly steady evolution of the GDP trend and by upsurges in inflation and a deterioration in the external balance similar to the level of additional growth in aggregate demand, and this has not usually happened; instead, it has brought upsurges in  $GDPa$ , something that is possible only if there is a gap between the two measures of GDP.

The conclusion, which has major implications, is that since the 1980s the region has routinely been operating well below its production frontier, with

<sup>4</sup> This definition of a recessive or output gap differs from the one used modally (two consecutive quarters of falling GDP). The modal definition seems relevant in economies with small fluctuations in economic activity, but not in the countries of Latin America.

FIGURE 2

**Latin America (19 countries): aggregate demand and GDP, 1990-2009**  
(Annual percentage growth rates)



Source: R. Ffrench-Davis, *Reforming Latin America's Economies after Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and updated figures from Economic Commission for Latin America and the Caribbean (ECLAC), *Time for equality: closing gaps, opening trails* (LC/G.2432(SES.33/3)), Santiago, Chile, May 2010, figure II.5, for 19 countries.

GDP: gross domestic product.

fluctuations that have carried output closer to or further from potential GDP, but without this ever remaining there. When GDPA has come close to GDP\*, it has usually been accompanied by large external deficits influenced by excessive currency appreciation. This represents a serious macroeconomic imbalance.

Whereas aggregate demand fluctuations prior to the 1990s were often due to fiscal deficits financed by printing money, it can be said as a rule that recent fluctuations have mainly been caused by external shocks in the capital account and terms of trade. Figure 3 presents an index of external shocks suffered by the region, including fluctuations in the terms of trade and net capital flows (net resource transfers) and their relationship with the evolution of aggregate demand.

One very important point is that, in many countries, fluctuations in the excess of spending over output (i.e., the external deficit) have largely been confined to the private sector.<sup>5</sup> The fact that

the fiscal accounts have become more stable and balanced allows the conclusion that instability in aggregate demand and the external balance is mainly a private-sector problem, as documented by Marfán (2005). This does not mean that fiscal policy has been fully balanced, efficient or effective in serving development and combating inequality; it simply means that procyclical fluctuations in the external balance have been concentrated more in the private sector than in the public accounts.

This behaviour has generally been due to the signals arising from the combination of a large supply of external financing and permissive, procyclical domestic macroeconomic policies (Kaminsky, Reinhart and Végh, 2004; Ocampo, 2007), many of them being lauded by the financial markets and risk rating agencies.

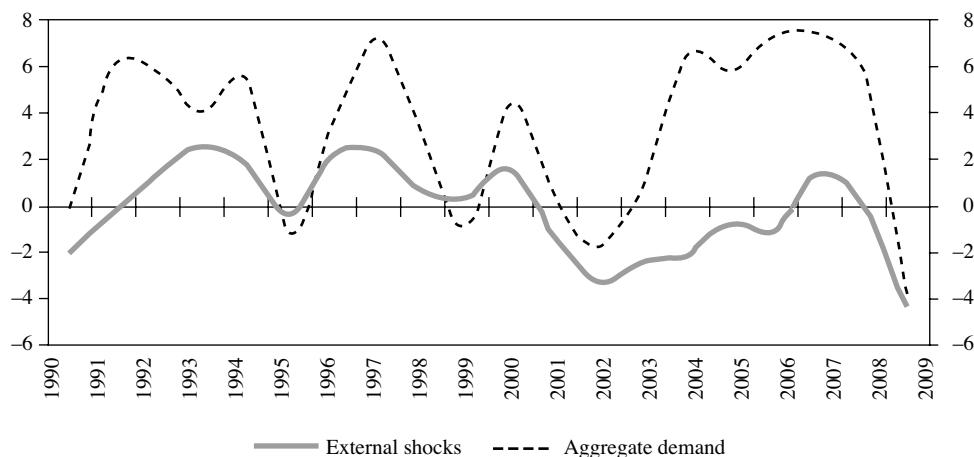
An adjustment process similar to the one seen in 1990-1994 and 1996-1997 took place again in 2004-2008, although with a boom essentially driven

<sup>5</sup> The transition towards imbalance has not started in national economies but has usually been caused by a positive external financial shock. The combination of growing external deficits with the build-up of international reserves during upturns is evidence of this. Following the initial external shock, the flow tends to

become endogenous as a result of procyclical domestic monetary and exchange-rate policies. An examination of different national episodes reinforces these conclusions for the region as a whole. See Ffrench-Davis (2006), chapter VII.

FIGURE 3

**Latin America (19 countries): external shocks and aggregate demand growth, 1990-2009**  
(Percentages of GDP, annual growth rates)



Source: R. Ffrench-Davis, *Reforming Latin America's Economies after Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and updated figures, based on official data from the Economic Commission for Latin America and the Caribbean (ECLAC).

Note: External shocks include net transfers of resources from abroad plus the terms-of-trade effect, both measured as percentages of gross domestic product (GDP). Net resource transfers include net capital flows (including errors and omission) plus the net factor income balance plus the net current transfers balance, excluding emigrants' remittances.

on this occasion by improvements in the terms of trade. A substantial part of this improvement involved higher public revenues, reflected in a reduction of public liabilities and sometimes the establishment of stabilization funds, with a rising primary fiscal surplus between 2003 and 2007 (ECLAC, 2009a and 2010, chapter II). The scale of the terms-of-trade improvement meant that the region had a substantial current account surplus at that time. The region was better placed now than in the two previous cycles, thanks to the build-up in its own resources and the reduction of liabilities. Consequently, when the external balance abruptly reversed in 2008–2009 with the international financial crisis, many of the region's governments were able to implement countercyclical policies to mitigate the recessionary and regressive effects of contagion (ECLAC, 2009a).

In parallel with their repercussions for aggregate demand, each of the cycles of expansion in the supply of external financing tended to generate a process of currency appreciation in most of the Latin American countries. Expectations of persistent appreciation encouraged financial agents, operating within the

time horizon of the appreciation outlook for local currencies, to channel additional funds into the region.<sup>6</sup> The experience of the Latin American countries has been that the real exchange rate, a macropice that is vital to decisions about production and spending on tradables, has behaved in an extremely procyclical way. Exchange-rate movements have been strongly correlated with cyclical financial capital flows (ECLAC, 2010, figure II.8). Every upsurge in the supply of funding has routinely led to large currency appreciations, and these have repeatedly resulted in overshooting of the current account. The combination of an open capital account, large liquid liabilities and emerging expectations of depreciation have led to large-scale and usually sudden capital outflows, generally accompanied by traumatic devaluations, once the markets have become aware of these vulnerabilities.

An outstanding implication for policy design is that a development strategy that is supposed to be led by exporting success cannot entrust the setting of the exchange rate to the “short-termist” behaviour of some financial agents; opting for this approach denotes a severe policy inconsistency.

## IV

### Intrinsically procyclical financial flows

An outstanding feature of recent macroeconomic crises in East Asia and Latin America is that they have affected economies classified as “successful” by international financial institutions, financial agents and risk rating agencies.<sup>7</sup> As a consequence, emerging economies have been “rewarded” with large flows of private capital and diminishing spreads, in parallel with a build-up of increasing volumes of external liabilities.

The Latin American countries have thus moved into areas of vulnerability: varying combinations of growing and highly liquid external liabilities; domestic

credit booms; currency and maturity mismatches; substantial external deficits; appreciated exchange rates; high stock market price/earnings ratios; high prices for luxury real estate; low rates of productive investment. At the same time, macroeconomic expectations have largely come to be dictated by the opinions of agents specializing in short-term segments of the financial market.

There is a very substantive literature on sources of financial instability: information asymmetries between lenders and borrowers and a failure to properly assimilate the negative externalities generated by each agent (in the form of growing vulnerability) have created the basis for cycles of abundance and scarcity of external financing (Krugman, 2000; Rodrik, 1998; Stiglitz, 2000; Harberger, 1985). As Heymann (2000) and Ocampo (2007) have emphasized, finance deals with the future, and concrete “information” about this is obviously not available. The tendency to equate opinions and expectations with “information”

<sup>6</sup> If appreciation is seen as lasting, this process will tend to discourage investment in the production of tradables that are intensive in local inputs. Consequently, it is very important to observe what happens to exchange rates during the expansionary phase or boom. This is when external imbalances and currency and maturity mismatches tend to arise.

<sup>7</sup> See Fanelli (2003), Frenkel (2003) and Reisen (2003) for complementary analyses.

contributes to a herd mentality and to multiple equilibria. And there have in fact been episodes of runaway contagion, first of excessive optimism and then of excessive pessimism, in the financial crises experienced over the last three decades, these imbalances often being encouraged by the risk rating agencies (Reisen, 2003).

An obvious contagion of overoptimism among lenders tends to be categorized as risk “appetite” among the agents following the “leaders”, but what prevails is ignorance or underestimation of the underlying risks.<sup>8</sup> Meanwhile, as discussed below, the “leaders” tend not so much to have a particular appetite for risk as to believe that capital gains are assured. As regards borrowers, at times of overoptimism the evidence is that most of them do not borrow with the intention of not repaying or in the hope of being bailed out or benefiting from a moratorium. What usually prevail are rather expectations of large benefits—from continued currency appreciation, for example. Borrowers also fall victim to financial euphoria during booms.

Beyond these factors, two further characteristics of financial creditors are of vital relevance in explaining why they tend to exhibit intrinsically procyclical behaviour. One is the particular nature of the leaders acting on the supply side. There are natural asymmetries in the behaviour and goals of different economic agents. Agents oriented towards the financial markets are specialists in liquid investment, operate within short time horizons and thus are extremely sensitive to changes in the variables affecting short-term returns.

The second characteristic is the gradual spread of information about investment opportunities in emerging economies among agents who are in a position to expand supply. Agents in the different financial market segments are gradually attracted to new international markets as they learn of profitable opportunities in emerging economies that they had hitherto overlooked or been unaware of. This explains, on the supply side, why capital flows into the countries of Latin America (in 1977-1981, 1991-1994, 1995-1997 and 2004-2007) have followed a growth path over periods of several years rather than there being sudden one-off upward shifts in the supply of capital.

<sup>8</sup> Calvo and Mendoza (2000) examine how globalization can spur contagion by discouraging the collection of information as it creates stronger incentives to imitate the portfolio of the market. This introduces a new information asymmetry, this time between market “leaders” and “followers”.

Feedback effects have been generated by the existence of installed capacity (potential GDP) that has been underused at the start of each of these processes and gradually brought back into operation during the upturn; this is something the authorities, markets and certain econometricians have often wrongly interpreted as a persistent structural increase in total factor productivity (TFP).<sup>9</sup> All this is self-reinforcing so that some variables—stock markets, exchange rates, risk ratings and real-estate prices—can move in a particular direction, first recovering and then overshooting so that they move away from sustainable equilibria for prolonged periods, offering economic agents the “assurance” that financial markets will move in only one direction and stimulating capital flows that pursue capital gains (rent-seeking flows).

This being so, it is important to highlight the significance for public policy design of the distinction between two different types of volatility in financial capital flows: short-term or random walk fluctuations and medium-term instability. The latter means that variables such as the exchange rate, stocks and shares and real-estate prices can move persistently in a particular direction, giving the market the false assurance already mentioned of asset prices and returns moving in a single direction. This stimulates further continuing flows that at some point become increasingly detrimental to macroeconomic fundamentals, but that still offer successive short-term windfall gains. These agents naturally specialize in the search for capital gains rather than productivity gains, until asset prices and the real exchange rate reach what are clearly outlying levels. Then someone sounds the alarm and there is a rush to reverse flows, with a strong and costly procyclical bias. Unlike fixed capital investment, which is to a large degree irreversible, this financial capital is wholly reversible.

Lenders’ sensitivity to bad news will increase greatly at some point (and probably quite suddenly) once the country has entered “areas of vulnerability”. Then lenders will take note of: (i) the volume of assets they hold in that market, (ii) the degree to which that market depends on additional net flows, something that is connected to the current account deficit, (iii) the level of exchange-rate appreciation, (iv) share price/earnings ratios and (v) the country’s stock of short-term and liquid liabilities. It is therefore unsurprising

<sup>9</sup> A systematic distinction between potential GDP and actual GDP would allow this faulty interpretation to be avoided, being an essential component of a development-oriented macroeconomic policy.

that expectations become more and more likely to reverse as valuations move further into these areas of vulnerability.

The deeper and longer-lasting an economy's incursion into areas of vulnerability, the greater the likelihood of crises and the severer their effects. This highlights the vital need to apply effective regulations to ensure that capital flows strengthen productive investment and are consistent with a sustainable macroeconomic environment. The composition, volume and deviation from trend of the flows are crucial variables. Against a background of ubiquitous structural heterogeneity, the explanation lies in the differing capacity for action and reaction of the agents typically operating in the different domestic markets.

To sum up, the interaction between two factors—the nature of agents and that of the adjustment process—accounts for the dynamic of capital flows over time: the factors leading suppliers to continue providing funds even when the real macroeconomic fundamentals are deteriorating.

Consequently, both the accumulation of external assets by providers of finance until this expansionary stage of the cycle is far advanced and the sudden subsequent reversal of flows can be considered "rational" responses by individual agents, given their short-term horizons. This is because the question of whether the real fundamentals are improving or worsening is not relevant to these investors as long as they continue to make investments motivated by expectations of short-term returns. What does matter to them is whether the indicators which are critical from their standpoint—real-estate, bond and share prices and the exchange rate—can continue to yield short-term gains and, of course, whether markets are liquid enough for them to reverse their decisions in a timely fashion if necessary. They will thus continue to originate net flows until expectations of an imminent reversal emerge.

It needs to be stressed again that, for financial operators, the most relevant variables are not the long-term fundamentals of the country's economy but the short-term returns it yields. This explains why their view of a particular country can alter swiftly and radically even though its economic fundamentals,

other than foreign-currency liquidity, may remain unaltered even as financiers' mood switches from overblown optimism to overblown pessimism.

Once debtor markets have made a "sufficient" downward adjustment, of course, the opposite process arises and can be sustained for some years, examples being 1991-1994 and 1995-1997, and probably the aftermath of the global crisis of 2008-2009. In conclusion, economic agents specializing in financial investments, who might be highly efficient in their field, operate with short-term planning horizons because of their training and the rewards they can thereby obtain, and they have largely dictated macroeconomic developments owing to the decisive influence they have had on policy design in the countries of Latin America. This means that a "financierist" attitude prevails over the "productivist" approach, and this enters into conflict with the twofold objective of growth with equity, which requires better incentives to increase productivity rather than giving priority to financial rent-seeking or capital gains. For growth with equity to be sustainably achieved, the views and priorities of the different economic and social actors need to be brought back into balance.

The heterogeneity characterizing the capital account in the recent era of financial globalization makes it essential to distinguish between the behaviour and effects of its different components. Greenfield direct foreign investment and long-term credits associated with imports of capital goods are relatively stable over the cycle, and are indissolubly linked to productive investment. By contrast, financial flows have shown great procyclical volatility, and this very property of theirs means that only a small share of them have gone into the financing of productive investment (Uthoff and Titelman, 1998); these flows usually end up financing purchases of existing assets and consumption, creating bubbles and crowding out national savings. Often, indeed, they have destabilized the macroeconomy instead of stabilizing it, and have not contributed to productive capital formation.<sup>10</sup>

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<sup>10</sup> Opposing positions in two important papers published by the International Monetary Fund (IMF) appear in Prasad and others (2003) and Singh (2006).

# V

## The recessionary and growth-depressing effects of instability in the real macroeconomy<sup>11</sup>

Real macroeconomic instability has recessionary and regressive effects, associated with price inflexibility, incomplete factor markets and the deep structural heterogeneity of the region's economies. The consequences, over the cycle, are various. One of them, the most standard in the literature although somewhat overlooked during these years of neoliberal fashion, is an increased disparity between aggregate supply and demand, the result being a recurrent gap between potential production capacity and its utilization, particularly in the stop phases that follow go phases. Demand is restrained in some sectors by full capacity utilization, while in others it is markedly inadequate. Consequently, in a stop-and-go situation, the instability of overall demand inevitably means that average net utilization is lower than production capacity and that actual productivity is lower than it would be in a situation of stable proximity to the production frontier. The greater the instability, obviously, the larger the recessive output gap and the worse the effects on the labour market, with increasing informality (ECLAC, 2010, chapter V).

### 1. Structurally heterogeneous markets and instability

The connection between inequality and instability in the real macroeconomy stems from the great structural heterogeneity characterizing developing economies. This includes the differing capacity for action and reaction of the agents typically found in different market segments (large versus small businesses, high- versus low-skilled workers, productive or GDP-generating investors versus financial investors or buyers of existing assets, productive investors versus consumers) and the asymmetries between their respective responses to the instability of economic activity and macroprices. During upturns (as opposed to a relatively stable trend in economic activity), liquidity constraints tend to be relaxed faster for consumers than for productive

investors, given the weakness of the long-term segments of capital markets. Again, consumers can react faster than productive investors because the latter need to identify, design and develop new projects, which is a lengthy process. Furthermore, the irreversibility of investment means that favourable expectations have to be perceived as sustainable by long-term investors before these begin new investment processes.

The production frontier obviously sets a bound to the recovery of actual GDP; only for short periods can this exceed potential GDP. During recessions, conversely, actual GDP can fall well short of potential GDP for long periods. Consequently, economic instability is intrinsically asymmetrical and, on average, inevitably entails underutilization of potential productivity and lower actual output. Recovery increases the flow of present output until the point where existing capacity is fully utilized, but output not generated in the past cannot be recovered. As long as the recessionary gap between the two levels persists, so will the depressive effects on productive investment, the labour market and the situation of small and medium-sized enterprises and informal sectors.

In consequence, the size of the gap between actual demand and the production frontier has major static and dynamic effects. First, it affects observed productivity (actual TFP) and the returns on projects implemented. Second, higher capital utilization rates generally mean that the average employment level is higher and the workforce interacts with a larger stock of physical capital in use. The consequent rise in observed productivity means that the welfare of workers and investors (wages and profits) can improve immediately, by virtue of the higher average capacity utilization index. Fiscal revenues also rise. The usual thing is for poverty to diminish in these situations, while the probability of an income distribution improvement rises during the recovery stage. The sign of the distributive effect depends on the micro- and mesoeconomic reforms accompanying recovery. Growth in itself may be either progressive or regressive. In the first case, it is usually sustainable and increasingly “endogenized”, in the second it tends to be reversible and limited (Bourguignon and Walton, 2007).

<sup>11</sup> A report prepared for the International Labour Organization (ILO) examines the effects of this instability, which are likewise regressive (Ffrench-Davis, 2010b).

## 2. Recessive gaps and the dynamics of capital formation

In the dynamic dimension, the degree of stability has a number of effects on the construction of the future. Higher utilization indices and the consequent increase in average actual productivity (in conventional econometrics this would appear as an increase in TFP) will tend to stimulate investment in new capacity. The dynamic effect on the investment ratio will be much more substantial if solid expectations are generated among economic actors regarding the ability of public policies to keep actual demand close to the production frontier, and if the authorities additionally undertake reforms to complete long-term capital markets while at the same time taking steps to improve labour force training and innovation.

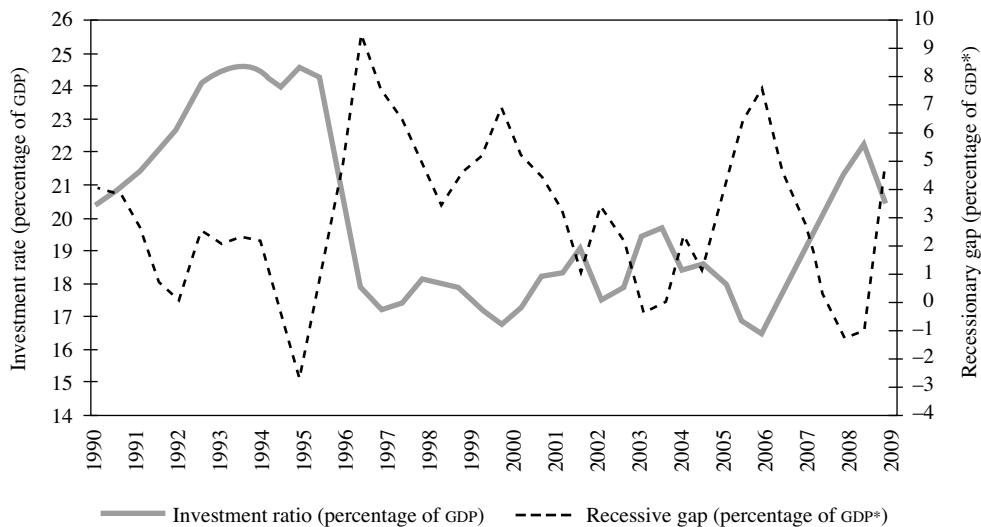
Figure 4 shows the close relationship that has existed between the recessive gap and the investment ratio in Latin America, reflecting one of the main negative dynamic effects of the underutilization of

production factors. This relationship is accounted for by a number of reasons (Ffrench-Davis, 2006, chapter III; Aizenman and Marion, 1999): (i) a large idle capacity naturally discourages investment in new productive assets; (ii) an environment in which economic activity and the exchange rate are volatile discourages irreversible investment; (iii) underutilization means lower profits and a lack of internally generated funding, usually coinciding too with a reluctance by the capital market to finance firms that have liquidity problems in recessions; (iv) the recessionary gap and its fluctuations tend to affect the quality of project evaluation; (v) the disincentives to the acquisition of new machinery and equipment dampen the technological innovation associated with these; and (vi) large recessionary fluctuations tend to depress public revenue, leading to cuts in the public investment needed to complement private investment (Easterly and Servén, 2003).

Figure 4 also shows the relevance of continuity in recovery processes and of the sustainability of

FIGURE 4

**Latin America (9 countries): the recessive gap and gross investment ratio, 1990-2009**



Source: R. Ffrench-Davis, *Reforming Latin America's Economies after Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and updated figures from Economic Commission for Latin America and the Caribbean (ECLAC), *Time for equality: closing gaps, opening trails* (LC/G.2432(SES.33/3)), Santiago, Chile, May 2010, figure II.9, based on data from ECLAC and A. Hofman and H. Tapia, "Potential output in Latin America: a standard approach for the 1950-2000 period", *Estudios estadísticos y prospectivos* series, No. 25 (LC/L.2042-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2003. United Nations publication, Sales No. E.03.II.G.205.

Note: Includes Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Plurinational State of Bolivia. The investment ratio measures the proportion between gross fixed capital formation and actual GDP. The recessive output gap measures the difference between actual gross domestic product (GDP) and potential gross domestic product (GDP\*) as a percentage of the latter.

the equilibria that arise as the recessionary gap is progressively closed. It reveals that more prolonged periods of economic recovery have led to an ongoing escalation of the investment ratio. The two-year period 2007-2008, when investment ratios were at their highest since the 1970s, followed the prolonged recovery that had begun in 2003; thereafter, with the contagion from the crisis, the ratio shed two of the percentage points it had gained up to 2008.

The case of Chile well illustrates the effects of the macroeconomic environment on investment. After averaging about 15% of GDP in the 1970s and 1980s, and following a recessive adjustment in 1990, the ratio recovered steadily to gain about 8 points by 1998 (Ffrench-Davis, 2010c). The persistence of the process is a crucial factor in effectively stimulating investors to tie up their funds and credit for the long periods production activity requires.

Paradoxically, fluctuations in the capital formation ratio have responded far more to economic cycles than to the micro- and mesoeconomic reforms carried out in the region to raise productivity and reduce structural heterogeneity. Assuming the macroeconomy were performing well, micro- and mesoeconomic reforms would be expected to determine the evolution of the investment ratio.

Consequently, there is a clear link between volatility and long-run economic growth that operates via its effects on the volume of fixed capital investment. Capital formation, in fact, functions as a major variable in the evolution of potential GDP, feeding through to employment and TFP (Ffrench-Davis, 2006, figures III.1 and III.2; De Long and Summers, 1991). The unsatisfactory experience of the region by comparison with the Asian countries can be attributed not just to the crucial issue of productive development policies, but to macroeconomic failures and the nature of the Washington Consensus capital market reforms (see section VI).

### **3. The instability of a crucial macropiece: the exchange rate**

Section III discussed the exchange-rate instability that has been generated by financial flows. This instability in the real exchange rate has been detrimental to the growth and diversification of exports and their integration into domestic economies (Agosin, 2007). Rates that fluctuate so much cannot be taken as effective reflections of shifting levels of “sustainable equilibrium”; “sustainable equilibrium” levels

respond to the evolution of relative productivity between the domestic economy and trading partners (and to volumes of net capital inflows that are sustainable and can be absorbed efficiently). The changes these “structural” variables undergo are usually gradual rather than sudden. Consequently, the large swings in many countries’ real exchange rates have generally been misalignments caused by procyclical capital flows.

Repeated cycles of currency appreciation, particularly after the substantial import liberalization that took place in the region (ECLAC, 1998, chapter V), meant that with each upturn, recovering aggregate demand from both individuals and firms has been increasingly import-intensive. Alongside a welcome increase in imports of capital goods, there have been large rises in other imports, many of them competing with savings and the output of local small and medium-sized enterprises (SMEs); thus, not only have the volume and quality of exports been crowded out, but so have production sectors that compete with imports.

### **4. Systemic competitiveness and the real macroeconomy**

It is meaningful for the analysis to examine where fluctuations in economic activity have been located. Between the 1990-1997 and 1998-2003 periods, for example, 90% of the adjustment in the region’s GDP growth (a fall of 1.9 points in the average growth rate) was concentrated in production for the domestic market, i.e., GDP that is not exported (Ffrench-Davis, 2006, chapter VI; ECLAC, 2010, chapter II). This reflects two facts, one micro, the other macro. The micro fact is the difficulty of repeatedly reallocating resources from the production of non-tradable goods to that of exportable goods and import substitutes and back. Switching policies in the region have been weakened by liberalization and changes in international trade institutions (ECLAC, 1998; Rodrik, 2008). Consequently, the main instrument actually available, namely the exchange rate, has become far more important. To decline to regulate it by permitting it to float freely without intervention by the economic authority is in stark contradiction with a strategy of export-led development.

The second point is macroeconomic. The GDP share which is not exported (about four fifths) depends on the local macroeconomic environment, while exports depend more on the global macroeconomy. The information available indicates that national

markets have been the main victims of instability (Ffrench-Davis, 2006, chapter V).<sup>12</sup> Here once again it is possible to appreciate the deficient quality of macroeconomic policy in the region, where it has

<sup>12</sup> Vigorous growth means that non-exported GDP also expands fast. This has been the experience of emerging economies with an export model that has been successful in productive development, examples being the Republic of Korea for several decades and Chile

been run very procyclically and has thus amplified rather than softened the transmission of external trade and financial shocks. The progress made over recent years remains insufficient.

between 1990 and 1998, when non-exported output grew by 6.5% a year (Ffrench-Davis, 2010c, table VII.6). In Latin America as a whole, on the other hand, non-exported output grew by a mere 2.7% (ECLAC, 2010, table II.2).

## VI

### Development macroeconomics: from “financierism” to “productivism”

Premature, indiscriminate and poorly sequenced liberalization of domestic financial markets and the capital account has become a source of costly destabilizing shocks. The high costs generated by economic cycles in the Latin American countries are related, as has been demonstrated, to the close links forged between domestic financial markets and procyclical segments of the international financial markets. As liberalization has taken place, there has been a major upsurge in financial saving without any increase in domestic saving, with a very low investment ratio and large fluctuations in economic activity and employment. The central cause is a financial market overly dominated by agents specializing in the short term rather than in productive investment. Consequently, only a small share of capital inflows have financed productive investment, a shortcoming aggravated by the financial and currency crises to which their volatility has given rise, and whose recessive effects have weighed down on capital formation by local companies and employment.

A consistent set of countercyclical fiscal, monetary, exchange-rate, domestic financial market and capital account policies is essential to foster a macroeconomic environment that allows potential GDP to be fully utilized and encourages the generation of new capacity.<sup>13</sup> For this to happen, such a development-friendly environment

needs to be complemented by efforts to “complete” markets for capital, labour and innovation.

In economies that are highly vulnerable to external shocks, relying on just one particular policy instrument during adjustment processes can produce macroeconomic outcomes inferior to what can be achieved by the balanced implementation of the different macroeconomic policies. Distributing the adjustment across different policies usually yields superior macroeconomic outcomes in terms of macroprices that are more closely aligned with sustainable levels and actual GDP that is consistently closer to its potential.

Procyclical, volatile flows are a component of external funding, which includes the foreign savings required to supplement domestic savings if a substantial increase in the investment ratio is to be achieved. An “all or nothing” option is therefore not viable. Thus, a fundamental goal of macroeconomic policies (and of reforms to domestic financial markets) should be to reap the potential benefits of external savings in support of national development, while moderating the intensity of capital account cycles and their negative effects on domestic economic and social variables.

#### 1. Fiscal policy

The international financial crisis has revealed the central importance of fiscal policy as a macroeconomic stabilization tool (Krugman, 2009; Griffith-Jones, Ocampo and Stiglitz, 2009; Blanchard, Dell’Ariccia

<sup>13</sup> ECLAC (2010, chapter II) examines these different macroeconomic policies. Ffrench-Davis (2008) provides a fuller analysis.

and Mauro, 2010). The concept of structural fiscal balance is an outstanding component of any countercyclical policy package. Its essential feature is budgetary measurement over the economic cycle to estimate what level of public spending would be consistent with trend public-sector revenue or full employment of productive capacity. Stabilizing spending in this way makes it more efficient and insulates it from cyclical fluctuations in fiscal revenue, while mitigating or removing the procyclical bias of an annually balanced budget policy. A number of countries in the region have been developing a form of budgetary planning that is not constrained by narrow annual limits. Chile is a particular example (Ffrench-Davis, 2010a).

Part of an approach of this kind is the creation of stabilization funds for fiscal revenues from exports whose prices are highly unstable. These funds can help to stabilize normal fiscal expenditure, provide supplementary financing for crisis situations like that of 2009, and additionally stabilize markets for foreign exchange by regulating its supply. For this, there is once again an essential need for close coordination between the fiscal authorities and those responsible for exchange-rate policy, which are usually based in different institutions (Martner and Tromben, 2004).

## 2. Monetary policy

Even if the countercyclical role of fiscal policy is successfully enhanced, however, this will not usually be enough. A crucial fact in the region is that fiscal spending accounts for only a fraction (around a fifth) of aggregate demand. Little will be achieved by operating an active fiscal policy over the cycle if other policies with a great influence on private-sector spending are dependent upon volatile flows and the opinions of procyclical financial agents.

Monetary policy, along with the independence achieved as regards financing of the fiscal balance, has been key to the large reduction in inflation rates. However, price stabilization can go together with large variations in the gap between potential and actual GDP (Blanchard, Dell’Ariccia and Mauro, 2010), as has been clearly demonstrated in practice. One critical feature of monetary policy is the weighting given to each macroeconomic variable in the work of the central bank; another is the coordination with other economic authorities already referred to. In a region where inflation is mainly in single digits, the tendency

for central banks to ignore other macroeconomic goals has lost the justification it might have had in earlier contexts of fiscal irresponsibility and high inflation. Mediocre outcomes as regards growth, employment and capital formation can be partly explained by the way these have been left out in the cold by policies that have focused on inflation targets without adequately considering the effects on these other areas that have such a critical direct impact on development.

For monetary policy to be genuinely countercyclical and contribute to development, explicit account must be taken of its repercussions on other macroeconomic variables such as economic activity, the recessive gap, external equilibrium and employment, with a sustainable balance between different objectives and the pursuit of indispensable coordination with fiscal policy rather than an exclusive concentration on maximizing anti-inflation effects. Real exchange rates are a macroeconomic variable that has brought severe conflict with anti-inflation policy. Inflation targets have frequently been met thanks to exchange-rate appreciation that has destabilized the economy.

## 3. Exchange-rate policy

The exchange rate is a macroeconomic variable that is essential for the sustainability of macroeconomic equilibria and resource allocation. Conventional approaches whereby the only exchange-rate options are a fixed nominal rate or a completely free float assume that the market will benignly set a sustainable equilibrium real exchange rate. Formally, a number of the region’s countries have adopted a free exchange-rate regime. Although central banks have intervened on a number of occasions to dampen fluctuations, real exchange rates have responded very strongly to changes in the balance of payments, more so than to changes in the current account.

Although the predominance of free-floating regimes prevented the kind of currency crises characteristic of fixed-rate regimes, many of the region’s currencies became extremely sensitive to procyclical changes in the supply of external funding. A severe contradiction therefore arose, with serious negative consequences for resource allocation and, especially, accumulation. Reforms to liberalize imports ushered in a leading role for tradable sectors, which meant that the exchange rate became crucial to international competitiveness (Williamson, 2000; Agosin, 2007; Rodrik, 2008; Eichengreen, 2008). Paradoxically, the authorities adopted a policy that

led to volatile exchange rates, dominated by short-term financial operators.

This obviously distorts project evaluation, encourages speculative rather than productive investment, artificially crowds out local production of importable tradables (many produced by SMEs) and discourages producers from adding value to exports.

This serious failure of exchange-rate policy is a severe constraint on export-led development strategies, particularly as regards non-traditional exports and those with greater value added that generate externalities and interact with SMEs. The management of exchange-rate policy is an essential component of the set of variables required for success in this area.

Intermediate regimes involving managed exchange-rate flexibility, such as different varieties of crawling pegs, dirty floats or both, represent a serious pragmatic attempt to correct this contradiction (Williamson, 2000). Neoliberal approaches tend to represent any exchange-rate intervention as going against “the market” and being doomed to failure. However, the idea behind the alternative approach we favour is to ensure that the real forces of the market—producers of exportables and importers and producers of importables, who are the major players in trade for production development and equity—are the ones that prevail in the setting of the exchange rate. This is the “market” that ought to set rates, rather than the market of short-term operators and rent-seekers imposing their interests over those of the drivers of innovation and productivity increases. Consistent, selective intervention by the economic authority is essential for this, even though it is obviously not infallible. It is always necessary to weigh the risk of mistakes when acting against the high likelihood of error when the exchange rate is left to float freely in a context of large flows of procyclical funds.

In summary, exchange-rate policy requires a far-reaching correction if it is to be consistent with a development strategy in which the production of tradable goods and services plays a central role. This would also contribute to systemic competitiveness, i.e., to the development of production capacity for both the domestic and external markets. The domestic market is home to the great majority of workers and firms. Improved systemic competitiveness achieved in this way helps to reduce domestic structural heterogeneity, a precondition for greater equality in the labour market and between the array of different-sized business.

#### **4. Creating deeper capital markets to finance development**

As this article has emphasized, the capital market has a major influence on macroeconomic equilibria, employment and capital formation. This is due to two features of the region’s economies. A very prominent one, first, is the “incompleteness” of capital markets, with some segments weak or non-existent. The distributive and resource allocation effects of capital market failures are aggravated by the marked structural heterogeneity between different economic agents, to the detriment of SMEs, low-skilled workers, innovation and agents with limited assets. Heterogeneity in access to financing reinforces inequalities in productive capabilities and participation in broader markets, in a vicious circle that condemns less well-capitalized production units to vulnerability and makes it hard for them to grow.

The close relationship with more volatile international financial markets that has been a feature of recent decades has exacerbated these shortcomings and bears part of the responsibility for low levels of productive investment and the fragility of labour markets. Indeed, that link has contributed to an intensification of instability.

##### *(a) From the Washington Consensus to innovative development financing*

Where interest rates and maturities are concerned, high financial costs have been the rule. Instead of “deep markets” for investment financing, as the neoliberal approach expected, the result has been markets that are deeply segmented and excessively focused on the short term (Stallings and Studart, 2005). The Washington Consensus reforms to domestic capital markets have actually tended to weaken development banking and the long-term segment. Consequently, these reforms have not been characterized by consistency with the recommendations of the Monterrey Consensus (United Nations, 2007), whose goal was to increase the resources going to economic and social development and give an effectively inclusive and countercyclical character to the working of capital markets.

National financial systems were certainly quite imperfect and inadequate before the Washington Consensus reforms, notwithstanding which they financed a higher investment ratio in the 1970s than was achieved under the neoliberal reforms, and supported substantially higher GDP growth

(see table 1 and figure 1). It would be unwise in the extreme to ignore these two realities and the contrast between them.

Consequently, the reform to the reform of national financial systems should be aimed at channelling resources into savings and productive investment, which generates sustainable jobs. The institutional structure required includes a vigorous long-term intermediation segment to allocate savings to productive investment, and there need to be prudential and countercyclical regulations. This system needs to include an active role for public- and private-sector development banks (ECLAC, 2010).

In emerging economies like those of Latin America, domestic markets are extremely difficult to reform when the capital account is indiscriminately open. Effective and efficient countercyclical regulation of the capital account emerges as an unavoidable condition of progress towards a development macroeconomics, with space for monetary policy and exchange-rate sustainability (Ffrench-Davis, 2006, chapters II and V; Ocampo, 2008). Regulation of capital flows can create space for consistent and countercyclical exchange-rate and monetary policies simultaneously.

Extreme liberalization of external financing, like that introduced since the 1990s, entails integration into the most speculative segments of international financial markets. Consequently, the most dynamic segment of the capital market has been large-scale financial activity involving short-term inflows and outflows, characterized not just by its procyclical volatility but also by the tenuousness of its links with productive investment.

Regulation of the more volatile capital accounts can act as a countercyclical macroeconomic instrument, acting on boom and bust cycles right at their source. It can mitigate pressures for currency appreciation and make it possible to adopt contractionary monetary policies in periods of financial euphoria. Also relevant is that the use of precautionary regulations during booms subsequently creates space for expansionary monetary and fiscal policies in episodes like the global crisis.

At the same time, countercyclical regulation of capital account inflows and outflows provides room for a reorganization of the domestic financial system aimed at channelling resources into productive investment with a bias towards inclusiveness, helping to reduce the structural heterogeneity between different economic and social sectors.

#### (b) *National experiences with countercyclical measures*

On the whole, experience with the use of restrictions on short-term or liquid capital inflows has shown them to play a useful role in creating space for countercyclical macroeconomic policies, thereby contributing to growth and employment (Ocampo, 2008; Stiglitz, 2000; Williamson, 2003). These restrictions are designed to create a more stable macroeconomic environment during booms and minimize costly recessionary adjustments in the retreat from positions of disequilibrium due to domestic overheating or external imbalance.

The success of the Chilean experience in the first half of the 1990s is a robust proof of the effectiveness of countercyclical regulations. Having recently returned to democracy, in 1990 Chile was confronted with a larger supply of external financing (relative to GDP) than other nations in Latin America, owing to its better economic performance, smaller economy and renewed political stability. This supply of funding was perceived by the authorities as an excess that would destabilize the country's macroeconomy (particularly aggregate demand and its consistency with potential GDP and a sustainable external balance) and its export strategy.

Accordingly, the authorities regulated the amount and composition of capital inflows by adding to the cost of short-term flows of funds, whether in the form of credits or stock market investments. This was done by establishing a non-interest-bearing reserve requirement (*encaje*), calculated as a proportion of the gross flow and to be held at the central bank for a given period, the rate of the *encaje* and period varying with the supply of external funding. By regulating the composition and amount of inflows, the reserve requirement provided effective room for simultaneously implementing active countercyclical monetary and exchange-rate policies (Magud and Reinhart, 2006; Edwards and Rigobon, 2009). They allowed Chile to maintain a level of aggregate demand consistent with its productive capacity and a sustainable exchange rate. These equilibria led to a substantial increase in the investment ratio and in the potential and actual GDP growth rate, with average GDP growth exceeding 7% a year. In the second half of the 1990s, Chile went along with more fashionable policy thinking and allowed the regulatory power of the reserve requirement to weaken before liberalizing the capital account in 2001 (Ffrench-Davis, 2010c, chapters VIII and IX; Le Fort and Lehmann, 2003).

It thus fell victim to contagion from the Asian crisis in 1999 and saw its GDP growth rate drop from 7.1% in 1990-1998 to 3.8% in 1999-2008.

The region has had a great variety of experiences with capital account regulation. Controls on capital outflows, combined with large fiscal deficits and clearly overvalued exchange rates, are usually very inefficient and destabilizing. The purpose of the capital account regulation proposed here is to achieve sustainable equilibria in the real macroeconomy, which is the opposite of seeking to perpetuate imbalances. In pursuit of these equilibria, some interesting regulatory experiments have recently been implemented in the region, largely to prevent excessive currency appreciation. Mention may be made of the cases of Argentina, Brazil, Colombia and Peru (ECLAC, 2009b).

Other regions can show many positive recent or current experiences with capital account regulation. The Republic of Korea is an example of an economy that maintained strict capital controls during a remarkable spell of economic growth lasting a third of a century. Following liberalization of capital inflows in the early

1990s, which led to its 1998 crisis, the country has maintained controls on residents' transfers of funds abroad (Mahani, Shin and Wang, 2005). Meanwhile, more traditional controls like those applied in China and India (such as bans on short-term financial borrowing, stock market investment quotas and controls on capital outflows) have proved very effective in achieving the macroeconomic objective of a more drastic weakening of the link between the domestic economy and the volatility of international markets (Ocampo, 2008). Both nations have successfully withstood the current crisis and their controls created the conditions for the remarkable recovery programmes now in operation.

In summary, reforms of the Washington Consensus reforms are urgently needed and should give greater priority to the linkages of the financial system (both local financial markets and the capital account) with the domestic investment process and the domestic economy than to those with short-term external financial markets. They should also improve the stability of domestic demand and macropolicies such as the exchange rate.

## VII

### The great macroeconomic challenge

These reflections come at a time when the world seems to have avoided what many analysts feared could have been a depression similar to that of the 1930s. That this did not occur was due not to good fortune or self-correcting markets, but to deliberate public action to correct the global macroeconomic situation. The correction ran counter to the dominant paradigm of a passive State and neutral economic policies. The response of the world's leading economies has been a vigorous countercyclical fiscal policy. With collapse avoided, fortunately for the great majority of the world's population, the task now is to deal with what is still a recessive situation and complete a set of corrections, both in global institutions and in each of our countries.

This article has documented how the choice of macroeconomic approach decisively affects the stability and speed of growth, and influences the degree of equity built into the structure of domestic

markets. National financial systems have a crucial role to play in capturing savings and allocating them to investment. Foreign capital, meanwhile, can play a valuable role as a supplement to local savings; the composition and stability of flows are crucial here. Indiscriminate financial liberalization proved highly inefficient as a way of achieving economic development and real macroeconomic stability and of reducing inequality. The global crisis—an example of the risks of unregulated "financierism"—has created space for more pragmatic policies and countercyclical regulation of the capital account in the region.

The way reform of national capital markets and their relationship with international capital markets is undertaken represents a critical challenge on the road to a sustainable macroeconomics that is conducive to economic and social development.

*(Original: Spanish)*

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