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## **I. MACROECONOMICS-FOR-GROWTH UNDER FINANCIAL GLOBALIZATION: FOUR STRATEGIC ISSUES\***

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### **INTRODUCTION**

Latin America has exhibited contrasting features in its economic performance in the last decade and a half of market-based reforms. There has been good progress in achieving low inflation, improved fiscal balances, and high export growth. However, in parallel, low average GDP growth, low productive investment, and high volatility of economic activity associated to changes in capital flows are outstanding features of the performance of Latin American economies (LACs) since the early 1990s. Here we examine their relation to the sort of macroeconomic policies that were implemented. Success in achieving low inflation and moderate fiscal balances, has not been accompanied by an effective demand close to potential GDP nor by interest and exchange rates providing sustainable signals for efficient resource allocation. The macroeconomic environment, in general, has been providing an unfriendly framework and wrong macro-prices for productive development.

In this chapter we document these features and offer policy proposals, particularly contributing to build into the market a macroeconomic environment prone for growth.

The incidence of capital flows on domestic economic activity has been an outstanding feature of LACs during the past quarter century. In the last ten years, East Asian economies joined the club. Actually, in recent decades, the association of flows with economic growth has been heterogeneous, and apparently has been worsening: on frequent occasions, capital surges have not been accompanied by vigorous capital formation and sustainable GDP growth. This fact highlights the central role played by the mechanism by which externally generated boom-bust cycles in capital markets are transmitted to the different host markets, and the vulnerabilities and hysteresis effects they may generate. This implies that an essential objective of macroeconomic policies is to reap the benefits from external savings, but reducing the intensity of capital account cycles and their negative economic and social effects on LACs, and more generally on emerging economies (EEs).

Capital account cycles are associated to the twin phenomena of volatility and contagion, both in the expansive phases and in the contractive episodes. Significant shifts in expectations, usually reinforced by subsequent risk-rating changes, lead to sharp procyclical adjustments in the availability of financing, maturities and spreads. The most damaging, as argued below, are the medium-term fluctuations rather than very short-term volatility: several years of abundant

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financing (i.e. 1991-94 and mid-1995 to 1997), followed by several years of dryness (most of 1998-2004).

In section 1, the arguments in favor of a generalized capital account opening by developing economies are analyzed. It is conventionally argued that capital inflows are a significant source for economic convergence for developing economies. We focus on what actually has happened with economic convergence and capital surges to EEs since the 1990s (first issue). In section 2, the implications of bust episodes are discussed. It is argued that all recessions leave significant lasting economic and social costs (second issue). Even the better-behaved recoveries usually end in a GDP plateau notoriously below the pre-crisis plateau. In section 3, it is analyzed why, repeatedly, crises are built, principally, in boom periods (third issue). The role of short-termist agents and *processes* of persistent positive shifts of the supply of funding during the boom stage are emphasized. In section 4, a contrast is presented between the 'orthodox' view of purely financial macroeconomic balances (limited principally to low inflation and balanced fiscal budgets), and an alternative approach concerned with comprehensive balances, that also includes employment, economic activity persistently close to potential GDP, and sustainable external balances. That is, 'macroeconomic balances of the real economy' (fourth issue).

## **1. Capital inflows for economic development convergence**

Flows of funds from capital-rich to capital-scarce countries, and catching-up in technological and managing innovation, are two crucial ingredients for a successful process of international convergence of living standards; to simplify matters, we use as a measure of convergence per capita GDP levels (see table1, below).

### a) Benefits from flows

#### *i. Flows from capital-rich to capital-scarce economies*

Mobilization of external savings is the most classic, and certainly the strongest, argument in favor of international capital flows to LDCs. At the aggregate level, capital movements from developed to developing countries are assumed to improve the efficiency of world resource allocation, because real returns on marginal investment in capital-rich countries are expected to be systematically lower than those in capital-scarce countries. Consequently, flows to LDCs can benefit both supplier and demander economies.<sup>1</sup> Indeed, net inflows of external savings can supplement domestic savings, raise productive investment and boost growth. In turn, expansion of aggregate income can further increase domestic savings and investment, thereby creating a

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<sup>1</sup> Recent literature argues that marginal returns to capital can be equalized without equalizing productivities. Gourinchas and Jeanne (2004, section IV) assert that this "would imply that the capital flows that need to be preserved are FDI, and not necessarily credit flows," as a way "to import productivity". This approach inserts in recent literature that underscores the weight of factor quantity on GDP growth. On the contrary, the fact that GDP per capita is strongly associated with the stock of capital per worker supports the view that the speed of capital formation is a significant determinant of GDP growth. In 2000, the capital intensity per worker of the US and the Latin American economies, was US\$111,000 and US\$16,000, respectively, in constant prices of 1995 (see Ffrench-Davis and Tapia, 2004; Ros, 2000, ch. 1).

virtuous circle in which there is sustained economic expansion, eventual elimination of net foreign debt, and transformation of the country into a capital exporter; it is the so-called virtuous debt cycle (ECLAC, 1995, ch. X), that contributes to the convergence of levels of economic development. LDCs more likely to receive private capital inflows are the EEs. Actually, they concentrate the overwhelming majority of private flows to LDCs.

Although obviously highly stylized, this traditional framework has some powerful implications. First, capital inflows should consistently be directed to augment aggregate investment, and not be diverted to consumption; that is, the crowding-out of national savings should be avoided.<sup>2</sup> Second, an aggressive domestic savings effort is called for: from the outset of a debt cycle, the marginal savings rate must attain a level much higher than the average rates of domestic savings as well as of investment; thus, it would eventually give way to a savings surplus. Initially, matching interest and profits remittances; subsequently, for the repayment of capital. Third, there must be efficient absorptive capacity in the domestic market; that is, investment must be allocated efficiently (requiring the supply of the other ingredients of the production function, -whether domestic or imported, for instance via FDI-, and a real macroeconomic environment suitable for productive investment). Fourth, the country must invest intensively in tradable goods and services in order to generate a trade surplus large enough to transform domestic savings into foreign currency, to service external liabilities. Fifth, creditors must be willing to provide stable and predictable flows of finance on reasonable terms.

These conditions may not all be complied with in practice: countries may experience a significant crowding-out of domestic savings by foreign savings; investments may not always be efficient or channeled sufficiently into tradables, and creditor behavior may differ from the desired pattern. Indeed, as convincing as the traditional argument for the transfer of international savings to relatively poorer countries is, the above problems and ensuing payments crises have often caused this valuable developmental mechanism to fail its target.<sup>3</sup>

#### *ii. Flows compensating shocks*

A second contribution of capital mobility is that it can help to balance transitory differences between output and expenditure, or to spread out over time the adjustment to permanent changes in relative prices; thus, it allows stabilizing consumption and investment, generating a stabilizing intertemporal adjustment. However, this counter- cyclical behavior not always does evolve smoothly in practice. Usually, it is not easy to ascertain whether a downturn in the external sector is transitory and, if so, for how long. This uncertainty, coupled with imperfections in international capital markets (especially informational asymmetries, enforcement obstacles, and contagion of changes of suppliers mood; see section 3, and Stiglitz, 2000), represent obstacles to the arrival of matching amounts of external finance at those times when they are required.

Given the smallness of EEs markets, *vis-à-vis* international financial markets, a stabilizing behavior is potentially feasible. However, that has happened systematically only during periods of generalized abundant supply. For instance, in 1991-97 (except early 1995 for

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<sup>2</sup> This implies that domestic savings increase, at least, in the amount that the rent of foreign capital rises.

<sup>3</sup> See the research presented in French-Davis and Reisen (1998), particularly, in Uthoff and Titelman (1998).

Latin America), the specific agent affected by a falling export price could borrow rather easily. On the contrary, in other cases, of moderate or weak supply, a worsening of the terms of trade has led to sharper dryness or to a consolidation of an already existing binding external restriction, as in 1998-2003; the outcome tends to be a private capital account contributing to a destabilizing intertemporal adjustment.<sup>4</sup> In these circumstances, financial markets, systematically, have pressed EEs authorities to face the negative external shocks with a pro-cyclical recessive policy.

When this second role of international capital mobility is played pro-cyclically, the costs of adjustment for developing countries can be enormous. That is because in the face of negative external shocks (and easily exhaustible domestic international reserves), any shortfall in capital inflows will require immediate cutbacks in domestic expenditure to restore the external balance. As discussed in section 2, output will almost certainly fall because of the natural rigidities standing in the way of resource reallocation, and a perverse hysteresis comes into action because there also tends to be an over-proportional cutback in investment (see section 4). The crisis-affected economy will be unable to return to the previous growth path; actually, it would be facing multiple equilibria.

### *iii. Flows diversifying risk*

Third, if analytically finance is treated analogously to goods, social benefits could be perceived in a multi-way international exchange in financial assets, since capital mobility would allow individuals to satisfy their risk preferences more fully through greater asset diversification; this is a micro-benefit. This argument has been widely-used for justifying a full opening of the capital account of developed and developing countries alike, particularly including the opening to outflows of domestic funds.<sup>5</sup>

There are several ways to diversify risk or insure against diverse types of risk. For instance, trade diversification and stabilization funds (including international reserves policy) to face exports and imports instability as a prudential macroeconomic policy. Sectoral and geographical diversification by the firm, and producers of goods and services operating with derivative markets (see Dodd, 2003). But, a different matter is capital account opening to diversify the financial assets and equity stock portfolio of residents.

It is evident that free trade in goods, as well as flows of greenfield FDI, and free trade in financial assets are not identical (Díaz-Alejandro, 1985; Devlin, 1989; Bhagwati, 1998). The former transaction tends to be complete and instantaneous, whereas trade in financial instruments is inherently incomplete and of uncertain value, since it is based on a promise to pay in the future. In a world of uncertainty, incomplete insurance markets, informational costs and

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<sup>4</sup> It is interesting to recall that it was public (multilateral and bilateral) supply of funds which behaved counter-cyclically in the 1980s and 1990s (see ECLAC, 2002a, ch. 4). Prasad, Rogoff, *et al.* (2003, section I.c and table 4), conclude that “procyclical access to international capital markets appears to have had a perverse effect on the relative volatility of consumption for financially integrated developing economies”. Kindleberger (1978) and Eichengreen (2003, ch. 2) provide interesting historical analysis of financial cycles.

<sup>5</sup> It is relevant that Korea and Malaysia –the two fastest recovering EEs after the Asian crisis– kept restrictions on outflows by residents as a countercyclical macroeconomic device (Mahani, Shin and Wang, 2004). Zahler (2005) discusses the macroeconomic implications of outflows from domestic institutional investors, illustrated with the case of Chilean private pension funds.

contagious changes of mood, *ex ante* and *ex post* valuations of financial assets may be radically different. The gap in time between a financial transaction and payment for it, generates externalities in market transactions that can magnify and multiply errors in subjective valuations, to the point where finally the market corrections may be abrupt, overshooting and destabilizing (Stiglitz, 1998); that would imply a macroeconomic cost. Thus, some form of regulation of trade in financial assets may not only make specific markets function more efficiently, but improve the overall performance of the economy through the enhancement of macroeconomic stability and better long term investment performance.

From the point of view of growth convergence, this third argument is not too relevant for enhancing development. First, for a given country, financial opening for the implementation of financial risk diversification implies liberalizing outflows by residents. Most, probably, it would tend to encourage net outflows from –the more incomplete, smaller, less liquid and less deep– developing or emerging markets, rather than the opposite. Evidently, that may diversify risk for domestic financial investors and agents that are able to invest abroad. However, likely, it does not diversify risk on returns to domestic producers, and probably reduces savings available domestically and, consequently, financing for productive investment.

Second, there are some interesting analytical pieces in the literature supporting this third argument. For instance, Obstfeld (1994) develops a model based on the hypothesis that global financial integration implies a portfolio shift from low-risk-low-returns capital to high-risk-high-returns capital. He concludes that that shift could contribute to “enormous welfare gains” (Obstfeld, 1998, p. 10). There are three comments I would like to pose in this respect: (i) the assertion about the size of the effects –even more than the sign– reveals an *a priori* belief or desire; (ii) there is an overlapping of the risk diversification argument with that of flows from capital-rich to capital-scarce markets in response to differential returns; there is need to identify what is truly different in the pure financial risk diversification argument;<sup>6</sup> (iii) actually, what do we observe? That cross-border flows tend to move into better-known and non-high risk assets; a look at stocks (for instance, ADRs or GDRs) and bonds of EEs transacted internationally, documents it sharply: they usually correspond to large, mature, and better graded domestic firms. In particular, the same happens with financial investment abroad of EEs residents. The exception, covering a broader set of assets, is in the case of the bubbles, in which investors actually do not reveal an appetite-for-risk, but rather an assumption away of risk during the contagion of over-optimism. In brief, there is no well-documented connection of risk diversification with the sources of domestic productivity increases.

Third, international financial diversification has presently being given evident priority in policy-making; for instance, when eliminating capital gains taxes on cross-border operations and in the encouragement to financial investment in offshore markets. But, the fact is that both activities are quite isolated from the sources of systemic competitiveness and productive development. That sort of priority tends to concentrate energy of economic agents in purely financial activities; this implies a *neo-rent-seeking* attitude: to make profits at the expense of

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<sup>6</sup> Other relevant argument is the obvious positive role fulfilled by financial intermediaries in relaxing liquidity constraints and in reducing search costs for small and medium sized agents (SMEs), which is crucial for economic growth and equity. It is domestic intermediaries who concentrate that role overwhelmingly. Access abroad of SMEs is notably limited.

other agents, instead of profit derived from increased productivity. The problem is not one of all or nothing, but of a rebalance in favor of ‘productivism’ and longer-term horizons.

In the post-war II period, global GDP growth has recorded high per capita rates. The average for the whole world in the last half-century is similar to the rates achieved by Great Britain and United States when they conquered, in that sequence, the role of more powerful economy in the world (see Maddison, 2001). The speed of world growth has shown a declining trend in recent decades, with GDP per capita rising 1.9% in the 1970s, 1.4% in the 1980s, and 1.1% in 1990-2004 (table 1). Of course, there are many other intervening variables in the evolution of GDP, but in this latter period there are two outstanding new factors<sup>7</sup>. One is the technological revolution taking place in recent years, evidently a positive contributing factor for increasing productivity and, we assume, generating higher growth; the other is the more intensive increase in domestic and international financial activism. This is a good candidate to explain, at least partly, the slower growth due to the deviation of resources and efforts from productivity enhancement (‘productivism’) and toward neo-rent seeking (‘financierism’), with a pro-cyclical bias. Efficiency, in any human activity, requires a sound balance between different activities, objectives, voices, time horizons, etc. That balance must be recovered.

(Insert Table 1)

#### *iv. Capital account opening and macroeconomic discipline*

This is the newest argument in favor of capital account liberalization. It states that the dependency from inflows can make a significant contribution to deter political authorities from following irresponsible and populist macroeconomic policies. It is argued that, consequently, fully opening the capital account would encourage “sound macroeconomic fundamentals”. This is partly true for *domestic* sources of instability, i.e., large fiscal deficits, permissive monetary policy and arbitrary exchange-rate overvaluation. However, actually, we have observed that lax demand policies or exchange-rate overvaluation has tended to be encouraged by financial markets during booms (in periods of over-optimism of financial agents), whereas excessive punishment during crises has tended to force authorities to adopt overly contractionary policies (“irrational overkill”).<sup>8</sup>

In fact, the opening of the capital account may lead EEs to import external financial instability, with capital inflows engendering a worsening in macroeconomic fundamentals. Thus, although this market discipline can serve as a check to *domestic* sources of instability –not necessarily very efficient, given the whims of opinions and expectations characteristic of financial markets– it certainly becomes a *source* of externally generated instability. Not only the market may perceive inaccurately that some domestic policies are inadequate, indeed, it may induce deviations of those variables from sustainable levels: it is the market itself which, during the booms, has generated incentives for EEs to enter *vulnerability zones* (see section 3).

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<sup>7</sup> In the case of Latin America there has been a significant financial and trade liberalization and massive privatizations, with much broader room for private markets. Analysis of reforms and outcomes are presented in Kuczynsky and Williamson (2003); Stallings and Peres (2000); Ffrench-Davis (2005).

<sup>8</sup> This source of market discipline can also pose obstacles to necessary social reform (for instance, to higher taxes to finance efficient human capital investment) or to the ability to capture economic rents from natural resources that otherwise be forgone.

One additional, most worrisome, implication is that legitimate national political authorities may lose the capacity to pursue the policy proposals for which they were elected. To this issue we turn at the end of this chapter.

b) Actual growth performance

Here we will focus on growth trends during the latter period. Given the three arguments discussed above in favor of capital account opening, we want to document whether there has been growth convergence during this recent period of broad liberalization of capital accounts and other structural reforms in EEs.<sup>9</sup> Table 1 shows that, in the 1970s, both East Asia and Latin America (notably Brazil) converged with the United States and progressed faster than the world economy. In the next two decades, East Asia continued to converge, though more mildly: it converged even in the most recent period (1990-2004), notwithstanding its 1998 recession. Latin America, on the contrary, has diverged since the 1980s (ECLAC, 2002b; IDB, 2004; Ocampo, 2005). In the period of deep free market reforms, significant liberalization of trade and high capital inflows, in 1990-97 (with a brief downturn in 1995), a significant share of foreign savings was not directed to capital formation (GKF), and of the fraction allocated to GKF a significant share was invested in the production of non-tradables<sup>10</sup>. Consequently, it generated severe vulnerabilities for the following period of supply drought (since 1998). Overall, annual growth per capita in 1990-2004 was merely 0.8% in Latin America, as compared to 1.1% in the world as a whole, and 1.8 % in the United States.

It is interesting that, within Latin America, there was a convergence in the adoption of neo-liberal reforms, but there was an increased divergence in economic growth of the region with respect to the USA and the world average. Table 1 shows that one exception in Latin American growth performance was the case of Chile, whose average growth per capita doubled that of the USA in 1990-2004 (3.6% versus 1.8%). Those years enclose two different subperiods; it is most relevant that a significant welfare convergence was achieved only in 1990-97 (with 5.3% per capita growth), period in which Chile searched quite actively for real macroeconomic balances, including the regulation of short-term and liquid capital inflows, active exchange rate and monetary policies, a significant fiscal surplus during boom periods and a copper stabilization fund by the Treasury. The set of policies initiated in 1990, with the return to democracy, represented a *reform to the reforms* conducted in the 1970s (Ffrench-Davis, 2002, ch. 10).<sup>11</sup>

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<sup>9</sup> An excellent, comprehensive re-interpretation of recent growth experiences is developed in Rodrik (2003); an earlier analysis is in Barro and Sala-i-Martin (1995). Prasad, Rogoff *et al.* (2003) present a comprehensive survey on the effects of financial globalization on LDCs growth.

<sup>10</sup> Two simple, straight-forward relations: (i) in 1990-97, net capital inflows increased more, in comparison to the 1980s, than GKF (even after changes in domestic savings are controlled by terms of trade); (ii) exports increased less than imports, and the standard way of measuring “tradables” usually exhibits a falling share in GDP, despite the significant rise in the export ratio. See Ffrench-Davis (2005), chaps. 3 and 4.

<sup>11</sup> Outstanding features of trade, financial and macroeconomic reforms of the 1990s in LACs were rather similar to those of Chile in the 1970s, sharing what I have shown to be severe mistakes, prone to financial crisis and ‘unfriendly’ with productive investment (see Ffrench-Davis, 2005, chaps. 1 and 3).

## 2. Recessions, recovery and elusive growth

A dominant feature of the 'new generation' of business cycles in EEs are the sharp fluctuations in domestic private spending and balance sheets, associated to boom-bust cycles in external financing. The rise of external financing contains a significant exogenous or push origin (Calvo, 1998); but actual inflows tend to produce policy changes, which introduce pull or endogenous factors. We interpret that the former effect prevails when a growing deficit on current account and appreciating exchange rates coexist with an accumulation of international reserves. That happened in most LACs in 1990-94 and 1996-97, and in East Asia in 1992-96.

External shocks, both positive and negative, are multiplied domestically if the exchange rate, fiscal and monetary policies stance are pro-cyclical, as it is actually expected to be by financial market agents and even by multilateral financial agencies. As a consequence of a pro-cyclical behavior, during the capital surges we have observed that EEs have, frequently, penetrated in *vulnerability zones*, during *adjustment processes* including some combination of (i) rising external liabilities, with a large liquid or short-term share (IMF, 1998; Rodrik and Velasco, 2000), (ii) large current account external deficits, (iii) appreciated exchange rates, (iv) currency and maturity mismatches, (v) high price/earnings ratios of domestic financial assets, and (vi) high prices of real estate. Bust in EEs, usually has come after a boom in capital inflows, which have been generating all these destabilizing market signals (Ffrench-Davis and Ocampo, 2001).

The longer and deeper the economy's penetration into those *vulnerability zones*, the more severe the *financierist trap* 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. The absence or weakness of policies moderating the boom –putting breaks during overheating<sup>12</sup> endangers the feasibility of adopting a strong reactivating policy under a recessive environment after the bust.

Bust has been led by a sudden stop of inflows and a sudden rise of outflows: Latin America in August 1982; Mexico in December 1994 and East Asia in 1997; or a somewhat more gradual change brought in by the Asian contagion<sup>13</sup> toward Latin America in 1998-99. All have implied a shift from liquidity to dryness in domestic financial and currency markets.

In this sort of crises, a downward adjustment on aggregate demand takes place after the drying of supply. The negative financial shock underlying the Asian crisis was compounded by a concomitant worsening of the terms of trade; evidently, there were no spontaneous capital flows compensating the swings of the terms of trade. Usually, there has been an 'automatic' component in the domestic adjustment, associated to a significant loss of reserves, complemented to different degrees, with policy-increased interest rates, depreciation and fiscal contraction. Evidently, the drop in domestic demand (or of its rate of growth) tends to correct the external deficit, and consequently that source of the demand for foreign currency. In all sharp processes, then follows a drop in GDP (growth), what tends to make necessary a subsequent additional fall in aggregate

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<sup>12</sup> A feature of the gestation of modern financial crises is that 'overheating' has taken place, frequently, with falling inflation rates, led by exchange rate appreciation and rising external deficits. A notorious case is that of Argentina in 1996-2001 with a negative average inflation in that period.

<sup>13</sup> We use a definition, which includes the contagion of optimism among financial agents during the capital surge, as well as a contagion of pessimism with the bust.

demand. Obviously, the larger the cumulative drop in GDP, the heavier the economic and social costs of adjustment and the foregone welfare. A positive feature, nonetheless, is that the resulting output gap (potential GDP minus actual GDP) provides room for a subsequent recovery.

Indeed in all moderately or well-managed economies, a recovery follows usually the fall in activity. We stress that most of the drop in GDP does not imply, necessarily, a destruction of capacity but a transitory underutilization, an *output gap*. That is a *recessive gap*. In a perfectly flexible economy, with an efficient combination of demand-reducing and switching policies there would be no output loss associated to the downward adjustment of aggregate demand. The actual huge GDP losses with respect to the previous growth trend, in all the cases we have observed, clearly signal that the universe we are dealing with is not too flexible vis-à-vis sharp recessive shocks, and that policies are not efficient or have become less efficient with the loss of effective tools.

Even in the outstanding cases of fast recovery –the so-called v-shaped recoveries– significant costs have been observed. Generally, countries, which have undergone severe crises, display evidence that they are pushed into a lower GDP path: in brief, an economy that exhibited a 7% growth trend and suffers a 7% drop, tends to experience a 14% output gap; consequently, a 7% recovery, in the year after recession, tends to leave a 14% gap. Figure 1 depicts the cases of Korea and Malaysia, that exhibit the better-behaved recoveries among EEs. Before the crisis, both were in a growth trend in the order of 7% per year, considered sustainable by most observers. Even these two outstanding economies, after 1998, remain notoriously below the previous trend<sup>14</sup>. Financial crises are extremely costly, stressing the importance of crises-avoiding reforms and policies.

(Insert Figure 1)

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 future path of potential GDP; for instance, the already mediocre investment ratios in LACs fell 1.5 points between the averages of 1992-99 and 2000-2003, reaching a ratio even lower than in the last decade of the 1980s (see section 4).

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; frequently, also, the Treasury or the Central Bank have diverted funds to support banks or debtor firms. Third, a growing body of evidence documents that boom-bust cycles have ratchet effects on social variables (Rodrik, 2001; World Bank, 2003). The deterioration of the labor market (open unemployment, a worsening in the quality of jobs or in real wages, and rise in informality) is generally very rapid, whereas the recovery is slow and incomplete. This is reflected in the long-lasting worsening of real wages in Mexico after the Tequila crisis (Frenkel and Ros, 2004); one crucial variable behind this outcome, that leaves negative 'structural' changes in the labor market, is that labor supply keeps rising, while capital formation experiences a sharp drop and the average rate of use of the stock of capital is reduced.

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<sup>14</sup> In econometric terms, this implies the existence of a unit root in real GDP.

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, and the need to reform the approach to macroeconomic policies (see section 4).

### **3. Why private non-FDI flows to EEs are procyclical and tend to destabilize macroeconomic balances**

Most recent macroeconomic crises in East Asia and Latin America have shown a close association with strong swings of private capital flows. An outstanding feature is that currency and financial crises have been suffered by EEs that usually were considered to be highly 'successful' by IFIs and financial agents; actually, they were awarded with growingly improving grades from international risk rating agencies (Ffrench-Davis and Ocampo, 2001; Frenkel, 2004; Reisen, 2003; Williamson, 2003b); accordingly, EEs were rewarded with falling spreads, in parallel with accumulating rising stocks of external liabilities (see figure 2 below).

The sharp increase of international financial flows since the early 1990s was notably more diversified than in the 1970s. But the outcome is potentially more unstable, in as much as the trend has been a shift from mid-term bank credit, which was the predominant source of financing in the 1970s, to a set of equity portfolio flows, liquid bonds, medium-and short-term bank financing; short-term time deposits; acquisitions of domestic firms by foreign investors. Thus, paradoxically, since the 1990s there has tended to be a *diversification toward highly reversible sources of funding*; they tend to share the spreads of over-optimism and over-pessimism. The reversibility of flows is not observed during the expansive-boom stage of the cycles, but its pervasiveness, for real macroeconomic stability, explodes abruptly with the negative change of mood of markets.<sup>15</sup> Notwithstanding the rising share of FDI along the past decade, the capital account still included a significant proportion of volatile flows, as well as inflows unlinked with the direct generation of additional productive capacity such as mounting mergers and acquisitions.<sup>16</sup>

That change in the composition of supply –associated to technological innovation, institutional and policy changes in developed economies, led by US authorities and powerful lobbying forces (Bhagwati, 2004; Pfaff, 2000)– was accompanied by a fast opening in the capital accounts of EEs, particularly in East Asia and Latin America; this opening was implemented in a period of abundant supply. The fact is that both regions moved into *vulnerability zones* (we repeat the signals: some combination of large external liabilities, with a high short-term or liquid share; currency and maturity mismatches; a significant external deficit; an appreciated exchange-

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<sup>15</sup> The accelerated growth of derivatives markets contributed to soften 'micro-instability' but has tended to increase 'macro-instability' and to reduce transparency. See an analysis of the channels by which stability and instability are transmitted in Dodd (2003).

<sup>16</sup> It must be recalled that about one-half of FDI inflows into Latin America in 1995-2002 corresponded to acquisitions and mergers (UNCTAD, 2003). Prasad, Rogoff *et al.* (2003, table 1 and figure 3) report data on volatility of total inward FDI, bank loans and portfolio investment. They confirm the conclusion from other abundant research that FDI is less volatile.

rate; high price/earnings ratios in the stock market, plus low domestic investment ratios in LACs). In parallel, as discussed below, agents specialized in microeconomic aspects of finance, placed in the short-term or liquid segments of capital markets, acquire a dominant voice in the generation of macroeconomic expectations.

There is an extremely relevant and interesting literature on the causes 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 (Krugman, 2000; Stiglitz, 2002; Harberger, 1985). Beyond those issues, as stressed by Ocampo (2003), finance deals with the future, and evidently concrete "information" about the future is unavailable. Consequently, the tendency to equate opinions and expectations with "information" contribute to herd behavior and multiple equilibria. Actually, we have observed a notorious contagion, first of over-optimism, and then of over-pessimism in many of the financial crises experienced by EEs in the last three decades.

However, 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 leading agents* acting on the supply side (Ffrench-Davis, 2003). There are natural asymmetries in the behavior and objectives of different economic agents. The agents predominant in the financial markets are specialized in short-term liquid investment, operate within short-term horizons, and naturally are highly sensitive to changes in variables that affect returns in the short-run.<sup>17</sup> The second feature is the gradual spread of information, among prospective agents, on investment opportunities in EEs. In fact, agents from different segments of the financial market become gradually drawn into new international markets as they take notice of the profitable opportunities offered by emerging economies previously unknown to them. This explains, from the supply-side, why the surges of flows to emerging economies –in 1977-81 and 1991-97– have been *processes* that went on for several years rather than one-shot changes in supply. In this sense, it is relevant for policy design to make a distinction between two different types of volatility of capital flows, short term ups-and-downs, and the medium term instability, which leads several variables –like the stock market, real estate prices and the exchange rate– to move persistently in a given direction, providing "wrong certainties" to the market and encouraging capital flows, *seeking economic rents* rather than differences in real productivity. Private capital flows, led by mid-term volatility (or reversibility) of expectations, usually have a strong and costly pro-cyclical bias.

On the domestic side, high rates of return were potentially to be gained by creditors from capital surges directed to EEs. At the time of their financial opening, in the 1980s and early 1990s (see Morley, Machado and Pettinato, 1999), Latin American economies were experiencing recession, depressed stock and real estate markets, as well as high real interest rates and initially undervalued domestic currencies. Indeed, by 1990, prices of real estate and equity stocks were

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<sup>17</sup> Persaud (2003), argues that modern risk-management by investing institutions (such as funds and banks), based on value-at-risk measured daily, works pro-cyclically in the boom and bust. Pro-cyclicality is reinforced by a trend toward homogenization of creditor agents. A complementary argument by Calvo and Mendoza (2000) examines how globalization may promote contagion by discouraging the gathering of information and by strengthening incentives for imitating market portfolio.

extremely depressed in Latin America, and the domestic price of the dollar was comparatively very high (see ECLAC, 1995; Ffrench-Davis and Ocampo, 2001).

In the case of East Asia, when they opened their capital accounts during the 1990s, the international supply of funding was already booming. As compared to LACs, they were growing notably fast, with high savings and investment ratios. However, equity stock was also cheap as compared to capital-rich countries (exhibited low price/earnings ratios), and liquid external liabilities were extremely low. Naturally, as discussed in section 1, 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 potentially space for very profitable capital flows from suppliers in the latter to the former markets. The expected adjustments in any emerging economy moving from a closed to an open capital account, in those conditions, should tend to be similar to those recorded in LACs. The outcome in both emerging regions, for instance, was a spectacular rise in stock prices, multiplying in average the price index by four in 1990-94 and (after a drop with the Tequila crisis) by two in 1995-97 in LACs, and by two in East Asia in 1992-94 (see Ffrench-Davis, 2003, table 2.1).

During the boom is when the degrees of freedom to choose policies are broader. 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 expectations of continued, persistent, appreciation encouraged additional inflows from dealers operating with maturity horizons located within the expected appreciation of the domestic currency<sup>18</sup>. For allocative efficiency and for export-oriented development strategies, a macroprice –as significant as the exchange rate–<sup>19</sup> led by capital flows conducted by short-termist agents reveals a severe policy inconsistency. The increase in aggregate demand, pushed up by inflows and appreciation, and a rising share of the domestic demand for tradables, augments 'artificially' the absorptive capacity and the demand for foreign savings. Thus, as said, the exogenous change –opened by the transformations recorded in international capital markets– was converted into an endogenous process, leading to domestic vulnerability given the potential reversibility of flows.

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: why suppliers keep pouring-in funds while real macroeconomic fundamentals worsen. When creditors *discover* an emerging market, their initial exposure is low or non-existent. Then they generate a series of consecutive flows, which result in rapidly increasing stocks of financial assets in the EE; actually, too rapid and/or large for an efficient absorption; frequently, the absorption is artificially increased by exchange rate appreciation, and a rising aggregate demand with an enlarged external deficit as a consequence.

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<sup>18</sup> For short-termist agents the actual and expected profitability were increased with the appreciation process. That same process, if perceived as persistent, would tend to discourage investment in the production of tradables intensive in domestic inputs. Therefore, it is most relevant, because of its policy implications, what happens with the behavior of exchange rates during the expansive or boom stage. It is then when external imbalances and currency and maturity mismatches are, inadvertently, being generated.

<sup>19</sup> The allocative role of the exchange rate was notably enhanced after the deep trade reforms implemented. See ECLAC (1995, chs. III and IV); Williamson (2003a).

The creditor's sensitivity to negative news, at some point, is likely to, suddenly, increase remarkably when the country has reached *vulnerability zones*; then, the creditors take notice of (i) the rising level of the stock of assets held in a country (or region), (ii) the degree of dependence of the debtor market on additional flows, which is associated with the magnitude of the current account deficit, (iii) the extent of appreciation, (iv) the need of refinancing of maturing liabilities, and (v) the amount of liquid liabilities likely to flow out 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 liquid external liabilities, the sensitivity to adverse political or economic news and the probability of reversal of expectations grows steeply (Calvo, 1998; Rodrik, 1998).

c) Rational (micro) financial agents and irrational macroeconomics?

The accumulation of stocks of assets abroad by financial suppliers, until well advanced that boom stage of the cycle, and, then, a subsequent sudden reversal of flows, can *both* be considered to be *rational* responses on the part of individual agents with short-term horizons. This is because it is of little concern to this sort of investors whether (long-term) fundamentals are being improved or worsened while they continue to bring inflows. What is relevant to these investors is that the crucial indicators from their point of view –prices of real estate, bonds and stock, 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 to supply net inflows until expectations of an imminent near reversal 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 for some years, like in 1991-94 or 1995-97, or short-lived like in late 1999 and 2000.<sup>20</sup> It is relevant for equity and average growth that the upward process usually tends to be more gradual or slower than the downward adjustment, which tends to be abrupt.

It is no coincidence that, in all three significant surges of the last quarter century, loan spreads underwent, in a *process*, a continued decline, notwithstanding that the stock of liabilities was rising sharply: spreads fell for 5-6 years in the 1970s; over 4 years before the Tequila crisis, and over a couple of years after that crisis. Figure 2 depicts the evolution of EMBI for LACs, exhibiting a persistent improvement between the first quarter of 1995 and the third quarter of 1997.

(Insert Figure 2)

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<sup>20</sup> Vulnerabilities were still significant in EEs when negative signals reappeared in the world economy in 2000, including the subsequent downward adjustment in the USA.

This behavior of spreads has implied, during the expansive side of the cycle, a downward sloping locus, drawing a sort of a medium-run supply curve, a highly destabilizing feature indeed. During all three expansive processes there has been an evident contagion of over-optimism among creditors and, rather than appetite for risk, there prevails an underestimation or assuming away of risk. In this respect, it is interesting to recall the evident parallel, in the 1990s, between spreads of Mexico (today praised as then a well-behaved reformer) and Argentina (today qualified as a non-reformer in that decade) (see Ffrench-Davis, 2003, figure 2.2). Apparently, creditors did not perceive any significant difference between these two economies until 1998.

With respect to debtors, in periods of over-optimism, most debtors do not borrow thinking of default and expecting to be rescued or to benefit from a moratoria. Contrariwise, expectations of high yields tend to prevail: borrowers are also victims of the syndrome of financial euphoria during the boom periods (Kindleberger, 1978).

In conclusion, 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. It implies that a 'financierist' approach becomes predominant rather than a 'productivist' approach. Growth with equity requires improving the rewards for productivity enhancement rather than *financial rent-seeking* searching for capital gains. There is need to rebalance priorities and voices.

#### 4. A macroeconomics-for-growth

There is a broad consensus that macroeconomic 'fundamentals' are a most relevant variable. However, there still is wide misunderstanding about what constitutes "sound fundamentals", and how to achieve and sustain them.

##### a) A two-pillar macroeconomics

The approach that has been in fashion in the mainstream world and IFIs, even up to today, emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances, with a clear omission of the overall macroeconomic environment for producers, which includes other most influential variables such as aggregate demand and exchange rates. We call it financial macroeconomic balances.<sup>21</sup>

This approach evidently includes other ingredients, but assumes, that the hard, relevant, proof is in fulfilling those two pillars. That leads to achieving productive development if the economy is liberalized, or that it becomes enough with the addition of microeconomic reforms. This approach is well illustrated, for example, by Stanley Fischer (1993), that after mentioning several intervening variables, concludes that "the evidence reviewed and presented in this paper

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<sup>21</sup> See analyses on shortcomings in the macroeconomic policies implemented in the 1990s in Latin America, in Williamson (2003a) and Ffrench-Davis (2005, chs. 2 and 9). As said, Prasad, Rogoff, et al. (2003), well documents the procyclical behavior of financial flows and some of its implications.

supports the conventional view that a stable macroeconomic environment, meaning a reasonably low rate of inflation and a small budget deficit, is conducive for sustained economic growth”. Additionally, a frequent assertion in the more recent conventional literature is that an open capital account imposes macroeconomic discipline to EEs.<sup>22</sup> Indeed, this approach assumes, sometimes explicitly or frequently implicitly, that full opening of the capital account would contribute to balance the external sector and automatically generate an aggregate demand consistent with productive capacity: It is well documented that that is not the usual experience in the frequent cases of external, positive and negative, financial shocks experienced by EEs (Ffrench-Davis and Ocampo, 2001).

As shown, LACs were successful in the 1990s in reducing inflation to one-digit figures, and balancing their fiscal budgets (fiscal deficits averaged, of course, with diversity among countries, less than 0.5% of GDP in 1995-97). In fact, several LACs fulfilled the main requirements of neo-liberal macroeconomic balances. However, economic activity was notably unstable, as depicted in figure 3; in the period covered, overall changes in GDP were led by ups-and-downs in aggregate demand, and these responded mostly to shifts in net capital flows; for instance, monetary adjustments were associated to changes in international reserves rather than to changes in domestic credit by the Central Bank (both are sources of high-power money).

The behavior of aggregate demand, at levels consistent with potential GDP, is a crucial part of a third pillar of real macroeconomic balances, which has frequently failed in neo-liberal experiences. As well, are well-aligned macroprices, like interest and exchange rates. Frequently, these prices and aggregate demand were out-of-equilibria, as reflected in economies working either below potential GDP or at full capacity with a large external deficit. They tend to miss the intermediate area where, precisely, mid-term equilibrium values are usually found.

East Asia fulfilled for decades real macroeconomic balances: low inflation, fiscal responsibility, together with sustainable exchange rates and external balances, and moderate interest rates (with a mild financial repression). In the 1990s, East Asia continued to fulfill the two conventional pillars –low inflation and fiscal surpluses– but lost the third pillar, of sustainable macrobalances for the real economy. Therefore, most EEs were implementing a financial or two-pillar macroeconomics at the outset of the Asian crises, with the euphoric support of specialists in *microfinance*. A *financierist* approach had become binding.

(Insert Figure 3)

b) Imbalanced financierism and macroeconomic instability

‘Financierism’ tends to lead, unsurprisingly, to unsustainable macroeconomic imbalances, with an effective demand that deviates sharply from the production frontier and with “wrong” or outlier macroprices and ratios. In figure 3, we observe a notorious mid-term instability of GDP growth for the total of Latin America; obviously, that of individual countries tends to be even more unstable. The data shows that changes in GDP have been led by ups-and-

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<sup>22</sup> A recent working paper of the IMF (Tytell and Wei, 2004) examines the “discipline effect” of financial globalization on macroeconomic balances, focusing on the two pillars in fashion –low inflation and fiscal balances– disregarding the other components of a comprehensive set of real macroeconomic balances.

downs in aggregate demand. Given that fiscal balances have characterized East Asia, and that LACs reduced their deficits during the 1990s capital surges, it is evident that increases in aggregate demand were intensive in private expenditure, an outcome strongly associated to the evolution of net capital inflows (Marfán, 2005). Actually, capital tended to flow from private sources to private users.

The resulting real macroeconomic instability in EEs, in this era of globalization, provides an undermined environment for productive investment. That is one strong force behind the poor achievement of LACs investment ratios in the 1990s, when they surpassed by merely one percentage point of GDP the 1980s average (19%), but remained about five points below that in the 1970s; with the contagion of the Asian crisis, in the present decade the investment ratio experienced a drop even below the level exhibited in the 1980s (see figure 4).

(Insert Figure 4)

c) The role of output gaps and capital formation

A significant, well-documented, variable underlining the drop in productive investment is the output gap between actual and potential GDP (Agosin, 1998; Schmidt-Hebbel, Servén and Solimano, 1996). The gap reflects the underutilized installed capacity in firms and other components of the stock of physical capital, falling employment and reduced actual total factor productivity (Ffrench-Davis, 2005, ch. 2). Profits tend to decrease while the mood of lenders becomes somber.<sup>23</sup> A notorious effect of these recessive situations, usually, has been a sharp reduction in investment ratios; for instance, a drop of fixed capital formation in 1995, of 13% in Argentina and 30% in Mexico; in 1998 fell 21% in Korea and 43% in Malaysia; in 1999 it declined 18% in Chile, and between 1998 and 2002, the drop recorded 56% in Argentina and 11% in all Latin America.

With the various episodes of economic recovery, investment ratios usually increased from their previous depressed levels (in 1985, 1990, 1995) as shown by table 4. However, there tended to persist a significant (although gradually reduced) output gap. Experience indicates that strong increases in investment are associated to a macroeconomic environment that is able to place effective demand at a level consistent with potential output, with right exchange and interest rates, and that situation is expected by private investors to be sustainable. Chile was the outstanding case to fulfill those conditions, and to exhibit a noticeable increase in the investment ratio in 1991-98 (see Agosin, 1998; Ffrench-Davis, 2002, chapters 1 and 10).

Two additional forces have strengthened the negative incidence of output gaps on domestic private investment. One is a change in the relative composition of FDI from greenfield investment to acquisitions (UNCTAD, 2003), stimulated by depressed prices of domestic assets and depreciated currencies; it is likely that many of these acquisitions would not have taken place under real macroeconomic equilibrium. The second is a negative response of public investment. In particular, expenditure in infrastructure. As documented by Easterly and Servén

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<sup>23</sup> The gap naturally differs among sectors, destinations, and type of firms. Where the gap is expected to persist, producers naturally will tend to postpone or cancel investment plans. In recessions, additionally, the financial sector restrains its lending activity, particularly to producers of non-tradables.

(2003), most LACs "witnessed a retrenchment of the public sector from infrastructure provision and an opening up to private participation". In most LACs, "private participation did not fully offset the public sector retrenchment".

The reported drop in investment ratios is a significant variable explaining why GDP growth was 5.6% in the 1970s, and averaged merely 2.5% in the fifteen years between 1990 and 2004.

It is policy relevant to disaggregate GDP into two components. One component of GDP are exports of goods and services,<sup>24</sup> whose demand is more closely associated with the external macroeconomic environment (and trade policies); the other is the rest of GDP –or non-exports– whose demand depends more intensively on the domestic macroeconomic environment. Actually, in the transit from boom to recession, the major share of changes in GDP growth rates has been located in non-exports performance, as can be estimated from table 2.

(Insert Table 2)

Given that in both regions the *value-added* by exports average less than half of GDP (about one-third in EA and one-fifth in LACs), a vigorous overall economic growth requires a significant growth of non-exports output. For instance, in Chile and in the average of the six East Asian countries, in the dynamic years 1990-97, non-exports rose about 6% per year (see table 2.A and 2.C.), while during recessive years (1998-2003) they were nearly stagnant in average. Figures for Chile (see table 2.C) are rather similar to those of East Asia for 1990-97 and for 1998-03. Non-exports rose 6.9% in the former period and 1.7% in the latter. Over 80% of the drop in GDP growth, from 7.6% to 2.6%, was explained by the recessive impact on non-exports. It can be expected that, in these situations, the large majority of GDP growth slow-down be explained by a rise in the actual/potential output gap in non-exports.

d) Toward comprehensive real macroeconomic balances

A comprehensive definition of macroeconomic fundamentals should include –alongside low inflation and a sound fiscal balance–, sustainable external deficits and low net liquid external liabilities, reduced currency and maturities mismatches, sustained public investment in human capital, high and efficient investment in physical capital, non-outlier real exchange rate, a crowding-in of domestic savings, and strong prudential regulation, supervision and transparency of the financial system. It is true that it looks like too many requirements; that is why sustained development is exceptional: few nations achieve it.

In boom periods, authorities should accumulate resources in stabilization funds, improve fiscal balances, increase international reserves, prepay external debt, avoid exchange rate appreciation, and regulate capital inflows. In recessive periods, it should imply, for instance, (i) continued 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 viceversa during the boom!!), and (ii) a strong

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<sup>24</sup> The relevant figures are the value-added to GDP by exports; that is gross exports of goods and services minus imported inputs.

encouragement to effective demand,<sup>25</sup> with switching policies when domestic activity is clearly below productive capacity (see French-Davis, 2005, ch. 2).

A severe obstacle to a counter-cyclical policy has been the policy in fashion of full, across-the board, opening of the capital account during booms. The predominant role exerted, during the recessive periods, by the policy recipe of IFIs and financial agents to pursue restrictive monetary and fiscal policies has tended to prolong the depressed economic activity in several EEs, and to generate a significant output gap.

Indeed, a macroeconomics for growth requires effective and efficient domestic policies. Certainly, the degrees of freedom in an increasingly (but also incompletely and unequally) globalized economy are more limited than before, but there is still space to choose among a wide variety of alternative paths to *make* globalization, and effectively capturing net benefit with it. The cases of passive economic approaches, like Chile before the debt crisis of 1982, Mexico in the first half of the 1990s and Argentina during the 1990s, have proved to be extremely costly for EEs, because of their high propensity to external crises.

On the other corner, we find that prudential domestic policies, such as the selective capital controls established in Chile and Colombia in the 1990s (see ch. IV, in this volume), can reduce the external vulnerability and allow for counter-cyclical exchange rate and monetary policies. Furthermore, even once a crisis has taken place, domestic policies are also crucial to minimize its negative effects and accelerate economic recovery. Korea and Malaysia, two countries that performed comparative quite well after their severe crises, followed different policy approaches but both developed active and consistent counter-cyclical macroeconomic policies (see Mahani, Wang and Shin, 2004), in contrast with most EEs, particularly in Latin America; their respective GDP evolution attest to it.

e) Financial globalization and governance

There is a growing duality, worrisome for democracy, in the constituencies taken into account by authorities in EEs. The increasing complexity and globalization of the economic system is raising the distance between decision-makers and financial agents *vis-à-vis* the domestic agents (workers, firms and tax proceeds) bearing the consequences. As discussed above, an outcome of the specific road taken by globalization has been that experts in financial intermediation –a microeconomic training– have become determinant, in too many cases, for the evolution of the domestic macroeconomic balances and their volatility.

The integration of capital markets has remarkable implications on governance, room for domestic policies, and on the constituencies to which national governments respond. In fact, many leaders in emerging countries are living a '*dual constituency syndrome*' (Pietrobelli and Zamagni, 2000; Stiglitz, 2001): on the one hand, political authorities are elected by their countries' voters, and promise to implement a platform designed before their election, but on the other hand they also seek, after being democratically elected, the support of those who "vote" for

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<sup>25</sup> Both Korea and Malaysia offer clear cases of fiscal and monetary encouragement to aggregate demand, plus a significant devaluation, to recover economic activity after their respective 1998 recessions (Mahani, Shin and Wang, 2004).

their financial investments (not necessarily productive investments or may be at their expense). Recent cycles in financial markets have revealed a significant contradiction between the two, in a negative-sum game, with large output gaps and discouraged capital formation.

In summary, 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, seeking sustainable growth with equity, 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, economic authorities should undertake the responsibility of making macro-fundamentals prevail (sustainable external deficit; moderate stock of external liabilities, with a low liquid share; reasonable matching of terms and currencies; crowding-in of domestic savings; limited real exchange rate appreciation; effective demand consistent with the production frontier), 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 or without a recessive traumatic adjustment like Argentina had to experience.

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Table 1  
**PER CAPITA GDP GROWTH IN SELECTED ECONOMIES,  
 1971-2004**

*(annual averages, percentages)*

	1971-80	1981-89	1990-2004
Korea	5.7	7.3	4.9
Malaysia	5.4	2.8	3.9
<b>East Asia (6)</b>	<b>5.2</b>	<b>4.4</b>	<b>3.7</b>
Argentina	1.2	-2.4	1.2
Brazil	6.1	0.1	0.3
Chile	0.9	1.1	3.6
Colombia	3.0	1.5	0.8
Mexico	3.4	-0.8	1.3
<b>Latin America (19)</b>	<b>3.3</b>	<b>-0.7</b>	<b>0.8</b>
<b>United States</b>	<b>2.2</b>	<b>2.5</b>	<b>1.8</b>
<b>World</b>	<b>1.9</b>	<b>1.4</b>	<b>1.1</b>

*Source:* Based on figures from ADB, ECLAC, IMF and the World Bank. East Asia includes Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand. Latin America includes 19 countries.

Table 2  
**GROWTH OF GDP PER COMPONENTS, 1990-2003**

*(annual averages, percentages)*

A. East Asia (6)

	Total GDP	Exported GDP	Non-exported GDP
1990-1997	7.1	10.9	5.7
1998-2003	2.9	7.6	0.6
1990-2003	5.3	9.5	3.5

B. Latin America (19)

	Total GDP	Exported GDP	Non-exported GDP
1990-1997	3.2	8.3	2.4
1998-2003	1.2	5.4	0.3
1990-2003	2.4	7.1	1.5

C. Chile

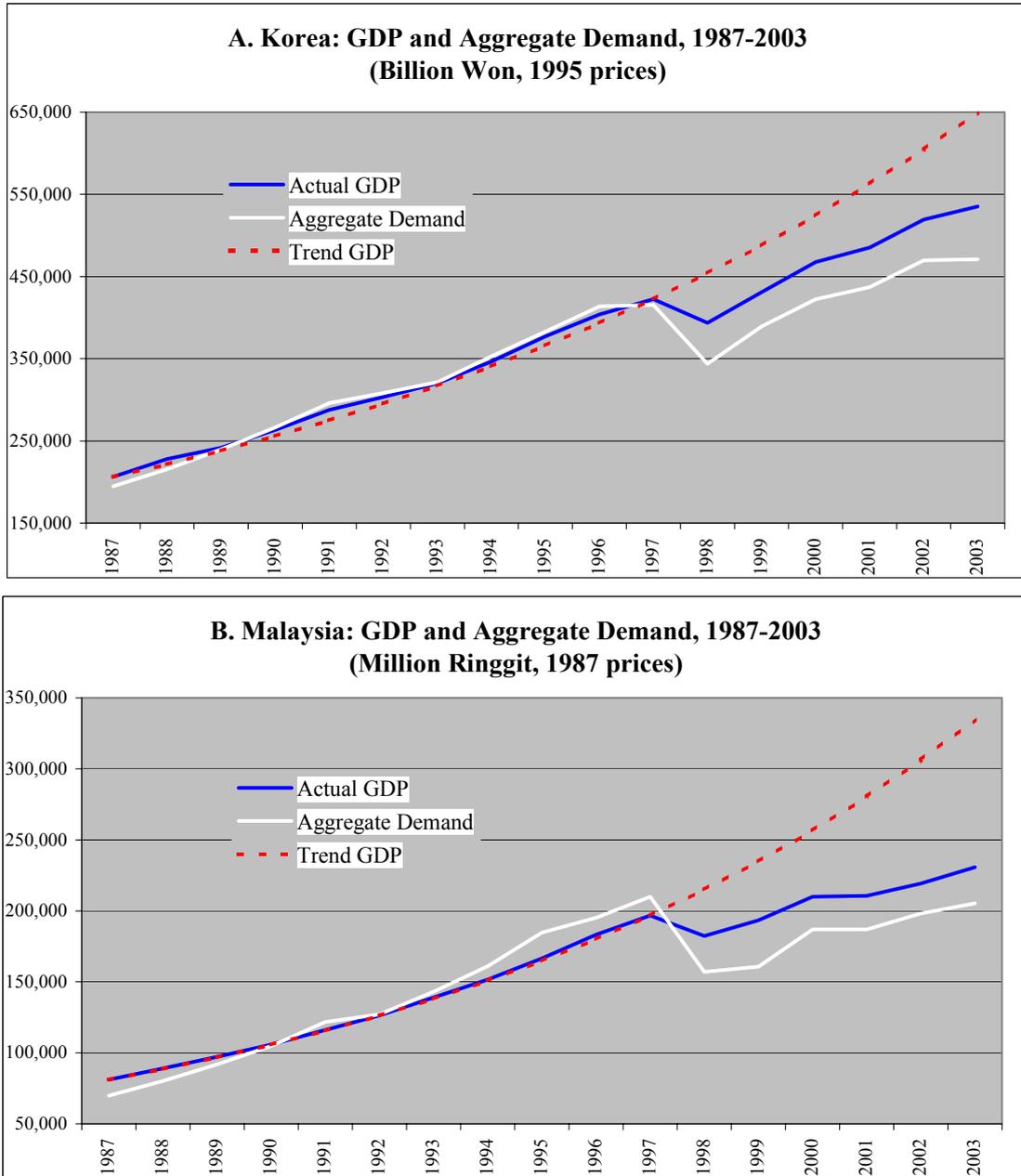
	Total GDP	Exported GDP	Non-exported GDP
1990-1997	7.6	10.5	6.9
1998-2003	2.6	5.7	1.7
1990-2003	5.5	8.4	4.6

D. Korea

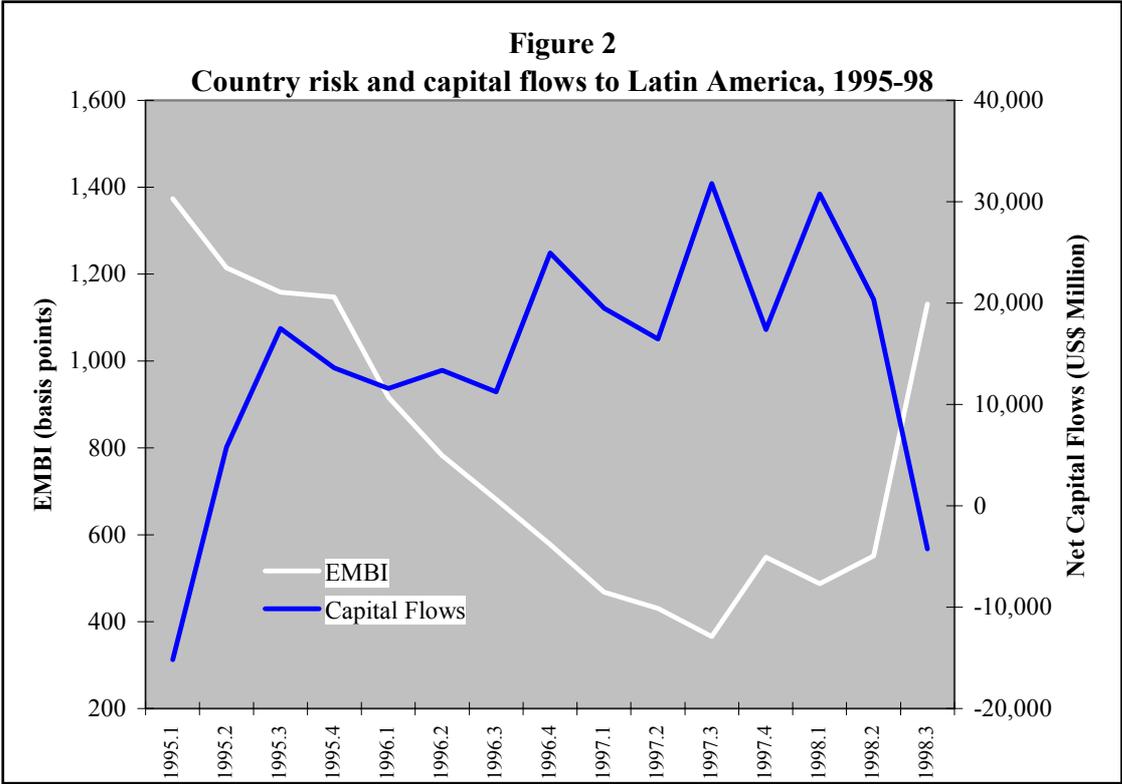
	Total GDP	Exported GDP	Non-exported GDP
1990-1997	7.2	13.9	5.4
1998-2003	4.0	11.9	0.1
1990-2003	5.8	13.0	3.1

*Source:* Author's calculations based on national account data in constant prices from ADB and ECLAC. 'Exported GDP' is an estimate of the value-added in exports of goods and services; naturally, it covers only part of 'exportables'. East Asia includes Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand. Latin America includes 19 countries.

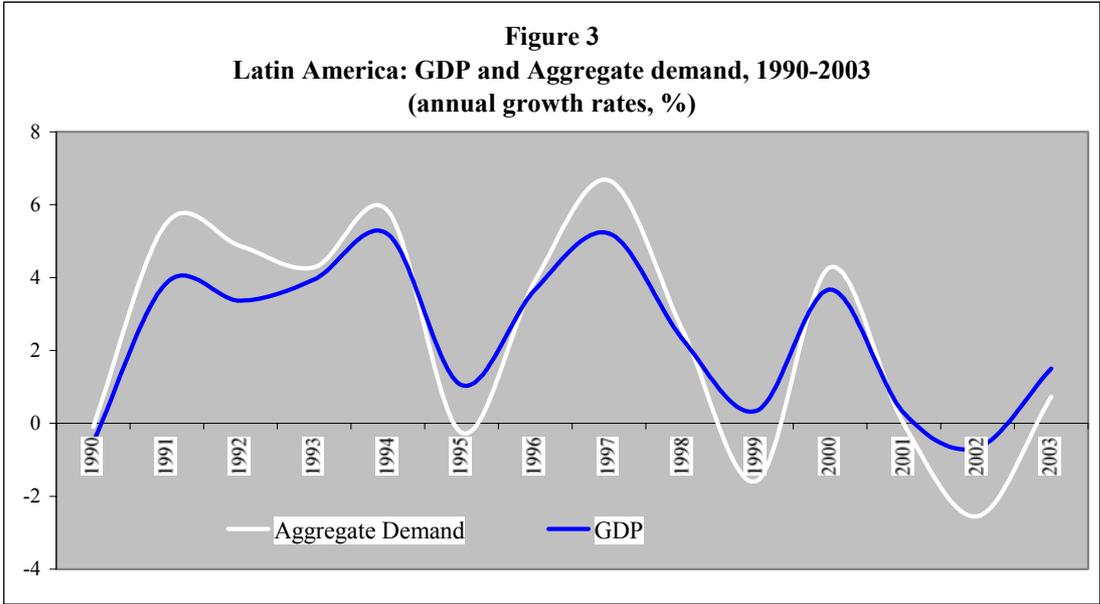
Figure 1



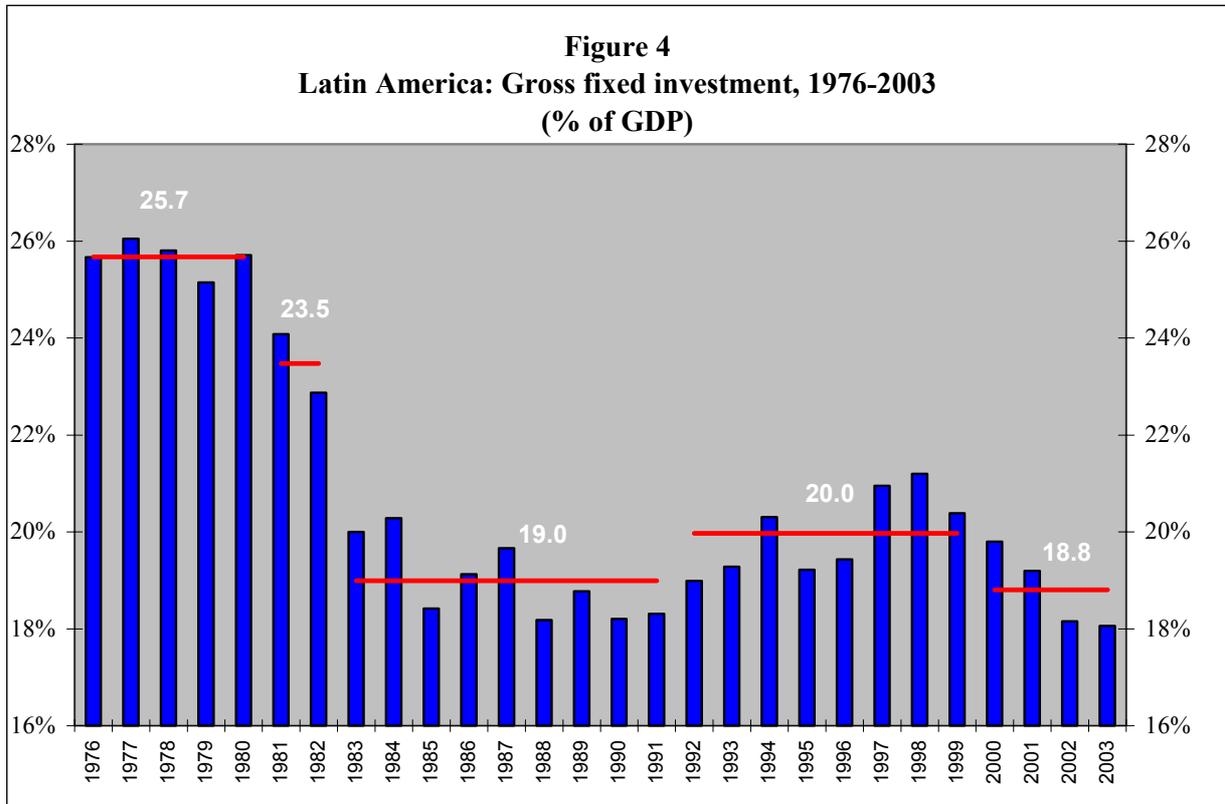
Source: Author's calculations based on ADB data.



Source: Bloomberg and IMF.



Source: ECLAC data. Includes 19 countries.



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