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Editorial

Overview of conference volume "Regional and International Implications of the Financial Instability in Latin America"☆

The late 1980s and early 1990s were an exciting time in Latin America. Following the perceived resolution of the debt crises, Latin American countries [LAC] became an attractive destination for foreign capital. Countries there engaged in market oriented reforms—financial liberalization, privatization, and the removal of trade barriers. At first, these reforms were viewed as successful, contributing to higher investment, consumption and growth. More recent events, however, have led to renewed pessimism, and to skepticism concerning the wisdom of market friendly restructuring. The turmoil in recent years, illustrated vividly by the drop in growth rates across the region, the meltdown of the Argentinean financial system, and the continuing struggle of Brazil to avoid a financial crisis, put to the fore the debate about the applicability of the "Washington consensus" to Latin America. Financial instability, and the inability to resolve the Argentinean crises efficiently and promptly, led observers to question the wisdom of the rapid opening of the financial systems. This includes the degree to which the architecture of the global financial system and the functioning of the IMF contribute to volatility in developing countries. Hence, Latin America is again at a cross road, where the earlier hopes of reaching a sustainable growth mode have been dampened. The importance of understanding these events goes well beyond the region. The varied experiences of different Latin America countries are providing a testing ground for the impact of reforms. Understanding the turmoil in LAC will shape the pattern of future policies affecting developing countries. In addition, the growing links between markets, both in number and magnitude, imply that turmoil in Latin America will spill over to other regions, leading to complex two-way interactions between Latin America and other affected countries.

In order to gain a better understanding of the issues involved, a conference under the aegis of JIMF took place on April 10-11, 2003, at UCSC. The conference dealt with the implications of the financial instability in Latin America. This volume provides the refereed proceedings of that conference. It includes seven papers which formed its core. In addition, it includes Barry Eichengreen's overview of advances

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in the last twenty years in modeling and understanding financial crises, based on Barry's conference key note address. The volume closes with Sebastian Edwards's perspective of the recent debate concerning the instability in LAC, identifying future challenges facing the region. His paper is based upon the conference's closing remarks. We start this volume with a brief overview of these papers.

In "Macroeconomic Policies and Performance in Latin America" César Calderón and Klaus Schmidt-Hebbel provide useful perspectives and new empirical evidence on macroeconomic policies in LAC, based on recent data for the region and the world at large. Their results challenge previous evidence which concluded that developing countries are characterized by the pro-cyclicality of macro policy. They report conditions under which monetary and fiscal policies could be counter-cyclical in emerging countries. Specifically, they link the cyclicality patterns of fiscal and monetary policy to credibility: both policies are counter- cyclical when country risk spreads are low to moderate, and the reverse when spreads are high. They confirm the role of institutions and show that the credibility of institutional design matters – the authors report that the accuracy of inflation-targeting central banks in meeting their targets rises with central bank independence and declines with country risk.

Calderón and Schmidt-Hebbel provide further evidence that the persistence of exchange rate regimes has changed significantly in the recent past in LAC, supporting the two-corner hypothesis. Intermediate regimes became less persistent than hard pegs and floats in LAC after the Asian crisis. In addition, most LAC switched from intermediate to floating regimes during the 1998–2002 period. The choice of exchange rate regimes and their transitions do matter for inflation and growth. Inflation in LAC is lower if the regime is less flexible, whereas growth in LAC is higher if it is more flexible. While inflation is higher and growth is lower in the transition from hard pegs to intermediate regimes, the opposite is observed when switching from intermediate regimes to floats: inflation declines and growth rises during some transition years. The authors do not find support in favor of the Harrod-Balassa-Samuelson hypothesis, that is, shifts in sectoral productivity growth are unable to track RER movements in LAC. In addition, they show that the contribution of very successful structural reforms—reflected in a massive growth jump—to the correction of RER misalignments is small. The growth-induced RER correction is too little and too late to avoid speculative attacks on an inflexible exchange rate. They report strong evidence of growing integration of LAC into world financial markets, reflected by declining saving-investment correlations and increasing real interest rate convergence. External factors are key in explaining long-term growth in emerging markets. Growth in LAC is enhanced by favorable terms of trade shocks, lower international interest rates, and larger private capital flows. External factors relative to domestic factors in LAC are the dominant cause of long-term growth, with a median contribution of 80% over the 1981–2000 period. Finally, the authors find that the composition of private capital flows is important for long-term growth in emerging countries. FDI inflows have a positive and significant impact on growth, whereas portfolio equity and debt flows do not.

The paper "Stock Market Cycles, Financial Liberalization and Volatility" by S. Edwards, J. Gómez Biscarri and F. Pérez de Gracia investigates whether stock markets have similar features in the emerging nations and in the advanced countries. The answer to this question is particularly germane to the current debate on the role of financial liberalization and macroeconomic instability in emerging and transition economies. The experience in recent years can provide an insight into these issues, because during the last decade emerging markets have been characterized by a high degree of financial instability. This has been particularly the case in Latin America, where currency crises have become recurrent, and where equity markets have experienced dramatic swings. During the late 1980s and early 1990s the vast majority of Latin American countries embarked upon ambitious market-oriented reforms. The results of these reforms provide a useful characterization of financial markets in developing countries. The authors found that the characteristics of stock market cycles in emerging markets differ quite markedly from those in developed economies—namely, bull phases tend to be shorter and bear phases longer, with the amplitude and volatility of both phases significantly higher than in developed-country markets. Yet, the financial liberalization processes have contributed to making Latin American stock markets more similar to those in more developed economies. Latin American stock markets after liberalization are more stable: Both cycle phases are less volatile and the amplitude of the phases has been significantly lowered, coming closer to that of developed countries. This is not the case, however, for Asian countries, which seem to have been intensely affected by the financial crisis of late 1997. In recent years, however, there is evidence that these countries, especially Korea, are recovering their stability. Concordance of cycles across markets has increased significantly over time, especially for Latin American countries after liberalization.

Most countries do not borrow abroad in their own currency, a fact that has been referred by Barry Eichengreen and Ricardo Hausmann as the “Original Sin.” Most countries do not borrow in local currency at long maturities and fixed rates even at home, a fact that is referred to as the domestic manifestation of the “Original Sin.” The paper “The Determinants of ‘Original Sin’: An Empirical Investigation” by Ricardo Hausmann and Ugo Panizza evaluates the incidence of the “Original Sin” and makes an attempt at uncovering its cause. The authors point out that the currency composition of foreign debt and the structure of domestic debt exhibit very large cross-country variations. First, internationally traded securities are denominated in very few currencies, mainly those of the large industrial countries and financial centers. Second, the few exceptions to this rule, such as the Czech Republic, Hong Kong, Poland, Singapore, South Africa and Taiwan are explained not by residents issuing internationally in the country’s own currency, but by foreign entities doing so. They argue that this may be a reflection of the presence of a positive correlation between currency risk and credit risk for domestic issuers. Third, they find a relatively low correlation between the ability to borrow internationally in domestic currency and the ability to do so domestically at long maturities and fixed rates. The authors report that countries such as Chile, Hungary, India, Israel, Philippines, the Slovak Republic and Thailand do not exhibit the domestic variant of Original Sin, but do exhibit the international variety. They find weak support for the idea that the level of development, institutional quality or monetary credibility and fiscal solvency are correlated with international Original Sin. The only variable that seems robustly related to international Original Sin is the absolute size of the economy. In the case of domestic Original Sin, the paper finds no correlation with the size of the economy, but does find that monetary credibility and the presence of capital controls are negatively correlated with domestic Original Sin.

Latin America is a volatile region with a history of exceptionally high inflation rates, substantial macroeconomic instability, and a record of unsuccessful attempts at monetary and fiscal stabilization. Not surprisingly, the credibility of stabilization efforts with the public is low, making the task of successfully implementing new stabilization programs very difficult. Latin American countries are also the most frequent users of IMF loans and associated IMF-supported stabilization programs. These programs' primary official objective is to restore balance of payments equilibrium and, in this context, IMF loans are granted (and the funds disbursed incrementally) conditional upon specific macroeconomic and other criteria being met. "Macroeconomic Effects of IMF-Sponsored Programs in Latin America: Output Costs, Program Recidivism and the Vicious Cycle of Failed Stabilizations," by Michael M. Hutchison and Ilan Noy investigates the impact of these programs in Latin America, in comparison to the impact of programs in other regions. They study the effects of IMF-supported stabilization programs in Latin America, and the reasons behind the unusually high IMF activity and relatively low program completion rates in the region. They base their tests on a panel data set, and distinguish between IMF program approvals and completion. They find that Latin America has higher output costs of IMF programs (especially when completed), no improvement in the current account, and a much higher likelihood of program failure and recidivism than other regions. The common finding that entering into an IMF-supported program incurs real short-run costs on the economy is entirely driven by the experiences in Latin America.

The authors deduce that IMF program failures/cancellations are more frequent in Latin America and the output costs of completing a program, when it does occur, are substantially higher than in other regions. Previous studies finding adverse effects of IMF programs may be entirely explained by the poor performance of Latin American countries when they enter into an IMF-sponsored stabilization program. Further, there is little evidence of substantial improvement in the current account when entering into an IMF program once the effects of sharp currency depreciations preceding program approvals are taken into account. The authors conclude that four related and self-reinforcing factors appear to explain this poor performance: external shocks combined with poor institutions, a history of poor macroeconomic management, the lack of policy credibility, and the nature of IMF-sponsored stabilizations.

The perceived success of inflation targeting and the Taylor rule, in contributing to macroeconomic stability in the US, has induced a growing number of developing countries to adopt this policy. Brazil adopted it in June 1999, and its recent experience provides fresh evidence for the ability of inflation targeting to facilitate adjustment in the presence of financial shocks. The paper "Inflation Targeting in Brazil: Constructing Credibility under Exchange Rate Volatility" by A. Minella, Paulo Springer de Freitas, I. Goldfajn and M. K. Muinhos is a case study assessing the recent performance of an inflation-targeting regime in Brazil. The authors note that the confidence crisis in the future performance of the Brazilian economy and the increase in risk aversion in international markets were responsible for a sudden stop of capital inflows in 2002. This caused a significant depreciation of the exchange rate. The inflation-targeting framework has played a critical role in macroeconomic stabilization. The authors stress two important challenges: construction of credibility and exchange rate volatility. Their estimations indicate the following results: i) inflation targets have worked as an important coordinator of expectations; ii) the Central Bank has reacted strongly to inflation expectations, consistent with the inflation-targeting framework; iii) there has been a reduction in the degree of inflation persistence; and iv) the exchange rate pass-through for "administered or monitored" prices is two times higher than for "market" prices. The inflation-targeting regime in Brazil is relatively new. Nonetheless, according to the authors, it has proven to be important in achieving low levels of inflation even in a context of large shocks, and has been a successful stress test for the inflation targeting framework. During this period, the regime has faced many challenges, including the construction of credibility—the change in relative prices, and exchange rate volatility—which remains a work in progress. Market expectations have stayed under control, even in the presence of inflationary shocks. Considering the intensity and magnitude of the shocks that hit the Brazilian economy in 2001 and 2002, the cost, in terms of output losses of a policy aimed at completely offsetting these shocks in a short period of time and keeping inflation within the tolerance intervals, would have been significantly higher.

In "Liquidity Protection versus Moral Hazard: the Role of the IMF" Andrew Powell and Leandro Arozamena evaluate the role of the IMF. Recent crises in Latin America have highlighted the problem of sudden stops in capital flows and the large costs for the countries concerned. It is difficult in practice to draw a clear distinction between sudden stops driven by fundamentals and pure liquidity "runs". Given potentially large swings in private capital flows, the role of the IMF in the region is particularly important, but also particularly complex. Broadly speaking, there are two schools of thought about the role and impact of the IMF. The "moral hazard school" stresses the perverse incentive problem created by insurance type interventions in capital markets. A second school, the liquidity school, stresses a set of failures in capital markets; asymmetric information between lenders and borrowers and co-ordination failures between lenders giving rise to problems including multiple equilibria. In this paper a model is developed that encompasses both. Runs may be a result of fundamental or pure liquidity concerns although, at the time of the run, it is not known which. The IMF can provide protection against pure liquidity runs but at the cost of moral hazard. It is suggested that, as both schools are right, it is precisely the tension between them that makes the task of the IMF so difficult. In the one stage game there is a unique Nash equilibrium, but in mixed rather than pure strategies. This implies that if cooperation cannot develop, the IMF is in a difficult position. On the one hand, the Fund would like to provide liquidity protection and stabilize capital markets but on the other hand it fears moral hazard. The equilibrium is where the Fund assists with some probability less than one in order to keep countries guessing, thereby reducing the moral hazard problem. One interpretation is that when policy makers stress the importance of a case by case approach, or central bankers speak in favor of constructive ambiguity, they are in fact admitting the need for a mixed strategy. In the repeated game, if cooperation can be supported, as the probability of insolvency rises, so does the probability of being assisted in the mixed strategy along with the incentive to deviate. This then gives rise to the possibility that there is an optimal "minimum punishment strategy" wherein the IMF plays a number of periods utilizing mixed strategy equilibrium to (just) ensure cooperation under one set of parameter values, but then the country deviates under a different set of parameter values. Under this strategy profile, deviations will occur when the probability of insolvency rises. The paper concludes that further creative thinking is required to complete the international financial architecture. The current situation implies that countries may "gamble for resurrection" before they default. The IMF will then find itself in an extremely awkward position attempting to provide liquidity protection but fearing moral hazard with vacillation being the equilibrium response. This does not imply that Latin American countries will be able to enjoy the benefits of international capital markets without the dangers of instability such as runs and sudden stops.

The recent collapse of the Argentine currency board raises new questions about the desirability of formal fixed exchange rate regimes in modern developing economies. "Currency boards, dollarized liabilities, and monetary policy credibility," by Mark M. Spiegel and Diego Valderrama, re-examines the merits and limitations of a currency board. Specifically, they study the impact of dollarized liabilities with potential default for a currency board with costly abandonment. They compare the performance of a currency board to a central bank with full discretion in two environments: One with only idiosyncratic firm shocks, and one with both idiosyncratic shocks and shocks to the dollar-euro rate. They find that the possibility of default with peso-valued exports generates a risk premium on borrowing tied to the expected future monetary policy. In addition, they find that the presence of dollarized liabilities mitigates the time-inconsistency problem faced by the monetary authority. Finally, the authors' numerical results demonstrate that the relative performance of the central bank under discretion, as compared to a currency board is ambiguous when considering firm shocks only, but that discretion unambiguously dominates when they also consider shocks to the dollar-euro rate.

The conference key note address, "Three Generations of Crises, Three Generations of Crisis Models," by Barry Eichengreen, provides an overview of recent developments in our understanding of crises. Eichengreen points out that, while the theory of balance-of-payments crises has come a long way in the last 20 years, we haven't made more progress towards its prevention. He identifies three reasons for this state of affairs. First, politics continue to lead governments to implement policies which create conflicts between internal and external balance. The importance of this point is hard to ignore in the context of Latin America today. Second, the problem of original sin highlights a major constraint on stability today, for which we, as yet, have no solution. Third, there is the progress of securitization. Today the typical emerging market bond issue is held by many thousands of different individual and institutional investors. This is a very different situation from the era of bank finance that extended from the late 1960s through the early 1980s. The presence of large numbers of investors encourages herding and creates collective action problems, making crises more likely to occur and more difficult to resolve.

Eichengreen's conclusion is that more attention should be paid to the political economy of policy making in emerging markets. More attention should be directed to the question of why emerging markets are on such an undesirable point on the risk-return tradeoff—why they can only borrow in foreign currency. And more attention should be devoted to understanding the incentives of market participants in the decentralized setting of contemporary international financial markets.

In "Financial instability in Latin America" Sebastian Edwards closes the volume with a macroeconomic research perspective, identifying what he views as the most important policy issues faced by the Latin American nations. These include the effectiveness of controls on capital inflows, the effect of exchange rate depreciation on output, and the international transmission of the business cycle. Edwards cautions us that generalized gloom among present commentators about the future of Latin America is not justified, and misses the subtleties of the economic and political dynamics in the region. Moreover, it is based on gross generalizations that ignore Latin America's rich diversity and heterogeneity. Different countries have different histories and traditions, and move at their own pace. He ends his contribution by reminding us that the economic research agenda on Latin America should not ignore history. This is a region with an incredibly rich historical past, and ignoring it may not only lead analysts in the wrong direction, but may also be costly from a policy point of view. In Latin America, more so than in any other region in the world, there has been a self-destructive tendency for repeating history.

Edwards' concluding remarks and the lead paper by Calderón and Schmidt-Hebbel remind us that, putting the present turbulent period in historical perspective, the glass is both half empty and half full. The resilience of some LAC, such as Chile and Brazil, suggests that there are constructive ways to deal with exposure to external shocks. While there is no escape from the need to undergo painful adjustment in the presence of adverse shocks, proper macroeconomic management, supported by well functioning institutions, facilitates adjustment without the need to undergo crippling crises. The hope is that the studies in this volume will motivate continuing research into these issues.

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