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informes y estudios especiales

Developing countries' anti-cyclical policies in a globalized world

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Introduction

The volatility and contagion characteristic of international financial markets, which dominated emerging economies during the 1990s, have deep historical roots.[1] Indeed, from the mid-1970s to the end of the 1980s, Latin America and many other regions in the developing world experienced a long boom-bust cycle, the most severe of its kind since that of the 1920s and 1930s. The shortening but also the intensity of boom-bust cycles have been distinctive features of the past decade. The latter is reflected, in the words of the Chairman of the Federal Reserve Board, in the fact that the "size of the breakdowns and required official finance to counter them is of a different order of magnitude than in the past" (Greenspan, 1998).

Viewed from the perspective of developing countries, the essential feature of instability is the succession of periods of intense capital inflows, in which financial risks significantly increase, facilitated and sometimes enhanced by pro-cyclical domestic macroeconomic policies, and the latter phases of adjustment, in which these risks are exposed and the pro-cyclical character of the measures adopted to "restore confidence" amplify the flow (economic activity) and stock (portfolio) effects of adjustment processes. An essential part of the solution to these problems lies in strengthening the institutional framework to prevent and manage financial crises at the global level.[2] This paper, however, looks at the role of developing countries' domestic policies in managing externally generated boom-bust cycles.

1 See, for example, in relation to Latin America, Bacha and Díaz-Alejandro (1982).
2 There is an extensive literature on these issues. See, for example, Eatwell and Taylor (2000), Eichengreen (1999) and Ocampo (1999, 2001, 2002).

It draws upon extensive recent literature on the subject [3] and upon the experience of Latin America in the 1990s.[4] The discussion is divided into seven sections. The first looks at the macroeconomics of boom-bust cycles in the developing world. The following sections look at the exchange rate regime, liability policies, prudential regulation and supervision, and fiscal stabilization. The final section draws some conclusions.

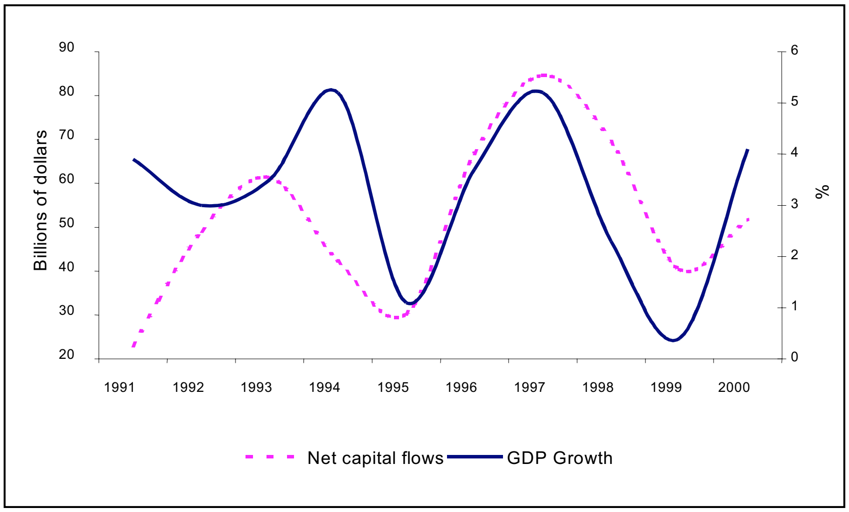
[3] Among the many recent contributions to the analysis of this issue, see ECLAC (1998a, Part Three; 2000, chapter 8), Ffrench-Davis (1999), Furman and Stiglitz (1998), Helleiner (1997), Ocampo (1999, chapter 5), Stiglitz and Bhattachrya (2000) and World Bank (1998, chapter 3).

[4] See ECLAC (2000, 2001 and 2002).

I. The macroeconomics of boom-bust cycles

The association between capital flows —and, more particularly, net resource transfers— and economic activity has been a strong feature of Latin America over the past decade (and, for that matter, the past quarter century), as Figure 1 indicates. This fact highlights the central role played by the mechanisms through which externally-generated boom-bust cycles are transmitted.

Figure 1
LATIN AMERICA: NET CAPITAL FLOWS AND GDP GROWTH



Source: ECLAC.

These mechanisms are well known. The boom encourages an increase in public and private spending, which will inevitably lead to an adjustment whose severity will bear a direct relationship to how excessive spending levels were, as reflected in accumulated liabilities. Thus, transitory public-sector revenues and readily accessible external credit during booms generate an expansion of public-sector spending, which will be followed by a severe adjustment later on, when those conditions are no longer present. A private lending cycle is generated by shifts in the availability of external financing and the cyclical patterns of international interest rates and spreads; availability and spreads are associated, in turn, with significant asymmetries in risk evaluation during booms and crises. Private-sector debt overhangs that have accumulated during the boom will subsequently trigger a sharp contraction in lending, usually accompanied by a deterioration in bank portfolios.

Poor prudential regulation and supervision of financial systems, and inadequate experience on the part of financial agents in risk evaluation, will lead to a significant underestimation of risks, further reinforcing credit expansion during booms. Both conditions are characteristic of periods of rapid financial liberalization. Nevertheless, even well-regulated systems are subject to periodic episodes of euphoria, when risks are underestimated. Private-sector borrowing and spending sprees spur sharp upswings in the prices of certain assets, particularly equities and real estate. This generates wealth effects that accentuate the boom in spending, but the reverse will hold true when spending, borrowing and, consequently, asset and real estate prices fall. This process is reinforced by the greater liquidity that characterizes fixed assets during periods of financial euphoria —i.e., when buyers are more readily available and financial decisions can be more easily reversed without incurring substantial losses— and by their reduced liquidity during crises. The use of assets as collateral will facilitate booms in private spending and borrowing, but it will then increase the vulnerability of the financial system during subsequent downswings, when it becomes clear that the loans did not have adequate backing. Asset prices will then plunge even further as debtors strive to cover their financial obligations and creditors seek to liquidate the assets received in payment for outstanding debts.

Capital-account booms —as well as high export prices— will also induce an appreciation of the exchange rate and exert adverse pressures on exchange and interest rates during the ensuing busts. Exchange rate fluctuations have significant wealth effects in countries with large net external liabilities. The capital gains generated by appreciation during booms further fuels spending booms, whereas wealth losses generated by depreciation have the opposite effect and may weaken domestic financial intermediaries. This is true even if prudential regulations forbid such agents from holding currency mismatches in their portfolio, as the capital losses incurred by non-financial firms with mixed external and domestic liabilities transform their currency risks into domestic financial risks. Thus, the wealth effects of exchange rate variations are pro-cyclical in debtor countries. The income effects may be so as well, at least in the short run, if the more traditional contractionary effects of devaluation prevail (Krugman and Taylor, 1978).

The associated macroeconomic volatility is costly in both economic and social terms. In economic terms, it increases uncertainty, reduces the efficiency of fixed capital investment and leads economic agents to prefer "defensive" microeconomic strategies that avoid committing fixed capital to the production process. For all of these reasons, it discourages investment. The higher risk levels faced by the domestic financial system biases lending toward shorter maturities. If severe enough, domestic financial crises will generate losses that amount to the equivalent of large proportions of GDP. In social terms, there is growing evidence in Latin America of ratchet effects of employment, poverty and income distribution through the business cycle.[5] This is associated with permanent losses in human capital during crises: workers who lose labor experience and connections and thus face permanent income losses; children who leave school and never return,

5 See, for example, ECLAC (2000, chapter 8; 2001c, chapter 3) and Lustig (2000).

etc. There may also be ratchet effects in the quality of public-sector services as the result of sharp cuts in spending.

The most important policy implication of this is that developing-country authorities need to focus their attention on crisis prevention, i.e., on managing booms, since in most cases crises are the inevitable result of poorly managed booms. Concentration on crisis prevention recognizes, moreover, an obvious fact: that the degrees of freedom of the authorities may be greater during booms than during crises. The way crises are managed is not irrelevant, however. In particular, different policy mixes may have quite different effects on economic activity and employment, on the one hand, and on the domestic financial system, on the other.

The following sections of this paper argue for a mix based on four different sets of policies: (a) managed exchange rate flexibility cum capital account regulations to provide room for counter-cyclical monetary and financial policies; (b) strong "liability policies" to improve countries' debt profiles (which include but go beyond capital account regulations); (c) counter-cyclical management of prudential regulation and supervision of domestic financial systems; and (d) fiscal stabilization. Given the reduced degrees of freedom that authorities have and the reduced effectiveness of some instruments in globalized markets, all policies have limited effects. Thus, pragmatic policy mixes in which these different elements support each other in their counter-cyclical task are called for. The specific emphasis will vary depending on the macroeconomic constraints and traditions of each particular country.