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# **Reforming macroeconomic policies in emerging economies: from pro-cyclical to counter-cyclical approaches<sup>\*</sup>**

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## **Abstract**

Macroeconomic fundamentals are among the most relevant variables for economic development. The commonly accepted approach in mainstream thinking and among international financial institutions in recent years emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances, with open capital accounts. We call these “financieristic” macroeconomic balances, and believe this approach underlies the present global financial and economic crisis. It implies a clear disregard for the overall macroeconomic environment for producers. As a consequence, in many emerging economies (EEs) “sound macroeconomics” (low inflation and fiscal discipline) is observed in parallel with slow growth, a high level of unemployment and low use of productive capital, which are the result of unstable aggregate demand, outlier macro prices and volatile capital flows.

In order to provide a macroeconomic environment conducive to sustained growth, a third pillar must be added, which is linked to the productive side of the economy. The behaviour of aggregate demand at levels consistent with potential GDP growth is a crucial part of a third pillar for real macroeconomic balances, which neoliberal approaches have frequently failed to consider. Similarly, other crucial ingredients are well-aligned macro prices, such as interest and exchange rates. This paper analyses alternative macroeconomic environments faced by firms and workers in the productive side of the economy (the producers of GDP), and the interrelationships between financial and real variables.

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## Introduction

The successful control of inflation and budget deficits has been a general trend among Latin American economies over the past two decades. However, the economic and social performance of many of those economies has been disappointing during that period. In spite of theories that predict economic development convergence with developed countries, a significant number of developing economies have displayed a divergence instead, and are experiencing a worsening of their already unsatisfactory social indicators such as poverty and income distribution. As a matter of fact, while the East Asian economies have been converging with developed countries, with annual rates of per capita GDP growth of 3.8 per cent in 1990–2007 compared with 1.7 per cent in the United States, Latin America has only matched the United States growth rate.

One main reason for the poor performance of several EEs is the absence of a comprehensive approach to macroeconomics beyond the necessary emphasis on the control of inflation and budget deficits. Moreover, in some countries (particularly in Latin America), explicit consideration for the real side of the economy has been disregarded. This narrow view has contributed to the deficient effects from the implementation of reforms associated with the Washington Consensus (Ffrench-Davis, 2008), and it still underlies the design of macroeconomic policies and the policy recommendations of international financial institutions (IFIs).<sup>2</sup>

Real macroeconomic balances are crucial for achieving a more dynamic and equitable form of development. Therefore it is relevant to learn how these balances are obtained, how sustainable and comprehensive they are, how consistent they are with macrosocial balances, and how they affect the variables underlying potential GDP (GDP\*).

From the productive point of view, efficient macroeconomic policies must contribute to: (i) using the available productive capacity by raising the rate of utilization of labour and capital in a sustainable manner; (ii) fostering capital formation; and (iii) increasing productivity through improvements in factor quality and their more efficient allocation. These are the three cardinal elements that can generate endogenous growth and increase the GDP growth rate during the transition to a new stationary level.<sup>3</sup> A high average rate of use of capacity implies reconciling the levels of actual aggregate demand and potential supply, and achieving a suitable mix of tradables and non-tradables as well as

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<sup>2</sup> See, for example, Singh, 2006.

<sup>3</sup> Related discussions can be found in Agénor and Montiel, 1996; Aghion and Durlauf, 2009; ECLAC, 2004 and 2010; Easterly, Islam and Stiglitz, 2001; and Rodrik, 2006.

appropriate macroeconomic relative prices, such as interest rates and exchange rates. Capital formation and actual total factor productivity (TFP) of that capital are vitally dependent on the quality of those balances.

For macroeconomic policies to make the most effective contribution to development, it is necessary to adopt a comprehensive overall view, which: (i) systematically takes into account the effects of those policies on productive development, (ii) reconciles the macroeconomic and macrosocial balances in a similarly integrated manner, and (iii) leads to trends that are sustainable over time.

The performance of the Latin American economies has been driven by a macroeconomic environment where the main agents – governments, entrepreneurs, workers and investors – have been facing sizeable fluctuations in aggregate demand, economic activity and macro prices. Significant successes in reducing inflation and improving fiscal responsibility have not been enough to achieve stability in the environment in which producers – both labour and capital – operate. Consequently, although overall GDP also responds to complex processes related to micro and meso structures, wrong macroeconomic policies have been one main factor responsible for the volatile and disappointing behaviour of output. This paper focuses on the definition of macroeconomic balances, and their overall impacts on growth. As capital flows have played a dominant role in emerging economies since the 1970s, their effects are central to the discussion in this paper.

The paper is organized as follows. Section 1 defines macroeconomic balances for sustainable growth. The analysis involves two contrasting approaches to macroeconomic balances that emphasize the relative weight of real versus short-term financial factors in economic decisions: a two-pillar financieristic balance, and a three-pillar real macroeconomic balance for development. It explores why financial instability has significant real permanent effects as a result of the gap between potential GDP and its actual utilization (referred to here as *output gap* or *recessive gap*); the positive dynamic implications of holding low output gaps for capital formation and actual TFP are stressed. Section 2 examines the connection between external shocks and the macroeconomic environment, highlighting the challenges confronting policymakers in dealing with the real business cycle and with destabilizing intertemporal macroeconomic adjustments. Section 3 analyses the role played by short-term segments of financial markets and the predominance of financial speculation and rent-seeking at the expense of investments in productive activities. Section 4 concludes.

## 1. Real macroeconomic balances

There is broad consensus that macroeconomic “fundamentals” are among the most relevant variables for promoting economic development. However, there is widespread misunderstanding as to what constitutes “sound fundamentals” and how they can be achieved and sustained.

The operational definition of macroeconomic balances has become so narrow that in many Latin American countries “a sound macroeconomic policy”, viewed as maintaining low inflation and small public deficits or surpluses, has been observed to coexist with slow growth, high unemployment and low capital utilization resulting from unstable aggregate demand and outlier interest and exchange rates. This section broadens the view of macroeconomic balances by also taking into account the relationship between financial and real variables.

### a) A two-pillar macroeconomic approach

The approach that has been in fashion in mainstream thinking and among IFIs, even up to the present, emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances. It clearly omits consideration of the overall macroeconomic environment for producers, which includes other very influential variables such as aggregate demand, and interest and exchange rates. We call the two pillars “financieristic” macroeconomic balances.

This financieristic approach evidently includes other ingredients as well, but the hard, relevant objective is the achievement of the two pillars noted above. It assumes that fulfilling that objective leads to productive development if the economy is liberalized (that is with the addition of microeconomic reforms, several of which have in fact been undertaken). This has been the established approach for about two decades, and continues to be the basis of the “remaining agenda” pushed by IFIs, particularly the IMF (see, for example, Fischer, 1993; Singh, et al., 2005; and Singh, 2006). Additionally, a frequent assertion in the more recent conventional literature is that an open capital account imposes macroeconomic discipline on EEs.<sup>4</sup> Indeed, this approach assumes, sometimes explicitly or frequently implicitly, that a full opening of the capital account would help impose external and fiscal balances, and consequently automatically generate an aggregate demand that is consistent with productive capacity. However, it is well documented that this is not the usual experience in the frequent cases of external, positive and negative, financial and terms-of-trade

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<sup>4</sup> A recent IMF working paper (Tytell and Wei, 2004) examines the disciplinary effect of financial globalization on macroeconomic balances, focusing on the two pillars in fashion – low inflation and fiscal balances – and disregarding the other components of a comprehensive set of real macroeconomic balances. A different robust view is developed in another IMF occasional paper by Prasad et al. (2003).

shocks experienced by EEs (Ffrench-Davis, 2006, ch. VI; Williamson, 2003). Understandably, concern for those two financial balances is justified, especially since several Latin American countries have suffered from hyperinflation. When present, this phenomenon rightly tends to become such a dominant concern that an anti-inflationary policy often becomes the leading and imperative objective of economic policies. Hyperinflation processes (see figure 1.c) have been the consequence of public deficits that are out of control and the printing of money to finance them.

In the 1990s, Latin American countries were successful in reducing inflation to single-digit levels and in balancing their fiscal budgets. Fiscal deficits averaged 1–2 per cent of GDP (though of course varying among countries) in 1994 and 1997 – the two years preceding the two recessive shifts of the 1990s.<sup>5</sup> Increases in money supply to finance public expenditure had become weaker or disappeared. Thus, many of these countries fulfilled the main requirements of neoliberal macroeconomic balances (see figure 1.c and d).<sup>6</sup>

Clearly, the two-pillar macroeconomic approach was not enough. At the same time, there was an increasing external deficit (see figure 1.a) that implied a greater degree of vulnerability. In boom periods, the excess of expenditure over domestic production or income was concentrated in the private sector (Marfán, 2005). In fact, during the boom stages of the economic cycle, while the external deficit (financed with capital inflows) worsened, the public sectors of many countries in the region registered marked improvements between the 1980s and 1990s until they were hit by the contagion effects of the Asian crisis. Growth of current-account deficits was frequently caused by the increased net expenditures of the private sector in the 1991–1998 period. This outcome was the combined result of the large supply of foreign financing and permissive domestic macroeconomic policies which allowed their destabilizing effects to transmit into the domestic economy; it is noteworthy that those pro-cyclical policies were usually praised by financial markets. Consequently, after the turbulences of 1994 (Tequila crisis), 1997–1998 (Asian crisis) and 2008 (global crisis), a significant recessive output gap reopened, with severe adverse effects on growth and equity (Ffrench-Davis, 2006).

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<sup>5</sup> It is inconsistent to assert that fiscal deficits were the cause of currency or financial crises on the basis of fiscal figures that refer to the period after the turmoil (for instance to 1998–1999); clearly, this would be indicative not of a cause but of a consequence of the crises.

<sup>6</sup> Also, economic reforms succeeded in improving export dynamism. However, trade reforms during episodes of appreciating real exchange rates frequently ended up causing an excessive destruction of tradable activities whose output (referred to as importables or import substitutes) was directed to domestic markets. Likewise, export development has remained too concentrated in commodities with low value added, which limits the transmission of export dynamism to the rest of the economy (see Agosin, 2007; Ffrench-Davis, 2006, chs. IV and V).

### **b) Toward real macroeconomic balances: Three pillars**

Financial macroeconomic balances alone cannot produce an environment that is conducive to high and sustained growth; a third pillar must be added, linked to the productive side of the economy. The behaviour of aggregate demand at levels consistent with potential GDP (also called productive capacity, installed capacity, or production frontier) is a crucial component of a third pillar of real macroeconomic balances. Also important are well-aligned macro prices, such as interest and exchange rates. Frequently, these prices and aggregate demand have been outliers (out-of-equilibrium) in neoliberal experiences, as reflected in economies working either quite below potential GDP (the most frequent result), or at full capacity but with a booming aggregate demand and a large external deficit.

One of the most fundamental macroeconomic balances refers to the rate of utilization of productive capacity. In economies with inflexible price systems and *incomplete* factor markets, both positive and negative shocks provoke successive adjustments. The results are greater disparity between supply and aggregate demand, with a consequent gap between potential productive capacity and the use made of it, particularly in the “stop” stages that follow the “go” stages. Unstable demand in a stop-and-go setting inevitably means a lower average net use of productive capacity and a lower average actual productivity than in a situation of stable proximity to the productive frontier. Naturally, the larger the instability, the larger will be the recessive output gap.

### **c) Instability, growth and equity**

Behind the emergence of output gaps is the extreme instability of GDP growth rates. As shown below in figure 4, Latin America has experienced volatile business cycles, with intense contractions and expansions. Evidently, the production frontier poses a limit to the recovery of actual GDP; only temporarily can actual GDP exceed potential GDP, while in recessive situations actual GDP can be notably below potential GDP. The implication of this annoying asymmetry is that average actual GDP under conditions of real macroeconomic instability is significantly lower than the average production frontier. This asymmetry, intrinsic to economic reality, has significant implications for defining the doses or degree of emphasis placed on the diverse objectives and policies, and for empirical research and econometrics (see Ffrench-Davis, 2006, ch. III, section 2).

The magnitude of the gap between effective demand and the production frontier has important static and dynamic effects. First, it affects the ex post productivity and profitability of the projects implemented. Second, higher rates of capital utilization mean that the average level of employment is higher and that the given labour force combines with a larger stock of physical capital in actual use.

Higher actual productivity means that the potential welfare of labour and rentiers (wage earners and profit makers) can improve in line with the higher average rate of use of capacity. If wages and profits grow, then fiscal revenue will grow as well. Consequently, workers, entrepreneurs and the government will be able to sustain higher consumption and investment, with a net positive effect on overall economic welfare. Third, in the dynamic dimension, there are several effects of the degree of stability. Higher rates of utilization, and the consequent increase in actual average productivity (in standard econometrics it would appear as a rise in TFP), will tend to stimulate investment in new capacity.<sup>7</sup> For the supply of investment to expand effectively, investors must perceive a real improvement in the short term, and expect that the reduction in the recessive output gap will be sustained in the medium to long term.

Figure 2, which shows the close association between the output gap and capital formation in Latin America, reflects one of the main negative effects of the underutilization of productive factors. This relationship responds to several factors:<sup>8</sup> (i) if there is plenty of idle capacity, there is less incentive to invest in new productive assets; (ii) a volatile environment deters irreversible investment (Pyndick, 1991); (iii) the recessive gap and its fluctuations tend to lower the quality of project evaluation and innovation; (iv) intense economic fluctuations tend to depress government revenues, which induces cuts in public investment, as discussed below.

Figure 2

Consequently, there is a clear connection between real volatility and long-term economic growth, which works through its effects on actual TFP and on the volume of investment in fixed capital.<sup>9</sup> Figure 3 shows the relationship between the growth of the capital stock and of GDP (both variables divided by the respective labour force) for 26 economies: 19 Latin American economies, 6 East Asian economies and the United States. In order to control for changes in the rate of utilization, rates of annual growth were calculated between 1980 and 2006 –

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<sup>7</sup> One significant explanatory variable of the low investment ratio recorded in Chile during the period 1974–1989 (the Pinochet Dictatorship) is the large average output gap predominating in that period (Ffrench-Davis, 2010, ch. I). The large size of the gap was associated with sharp and abrupt drops, with gradual macroeconomic recoveries.

<sup>8</sup> The negative effect of volatility on investment has been found to be statistically significant by a number of econometric studies (see, for example, Aizenman and Marion, 1999). Aghion et al. (2005) and Ramey and Ramey (1995) tested econometrically the connection between volatility and growth, and found a significant negative relationship.

<sup>9</sup> Other two key relationships are an increase in potential productivity, brought about by technological change, and the formation of human capital. It must be borne in mind that technology frequently needs to be embodied in factors of production (physical and human capital) in order to be part of the production function. Even intangible technology associated with the organization and generation of institutions usually requires investment in equipment and infrastructure, and depends on a more highly skilled labour force.

two years of relatively buoyant economic activity in the sample.<sup>10</sup> It is well documented that the increase in the capital stock accounted for much of the GDP growth in those economies.<sup>11</sup>

### Figure 3

Moreover, most of the differences in growth between the Latin American countries and the more dynamic countries of East Asia are attributable to the rapid growth of capital stock. Figure 3 also illustrates the “disappointing” non-convergence of Latin Americas with the more developed countries. In fact, the United States and the East Asian countries have been growing faster than almost all the Latin American region (where Chile is an outlier, but it only began to converge rapidly in the 1990s).

Another dynamic consequence of lower macroeconomic volatility is a tendency towards greater equity.<sup>12</sup> This links comprehensive real macroeconomic balances with *macrosocial* balances (including poverty and income distribution). Indeed, low-income sectors, with less human capital and with small and medium-sized enterprises, have less capacity to react to continuous abrupt changes. During periods of expansion, the rate of inflation normally accelerates, and it is the poor who have problems protecting their assets and income against the “inflation tax.” The period of downward adjustment tends to be accompanied by falling wages and employment, along with a shift from formal to informal markets (Tokman, 2004). This has a negative impact on consumption and on the wealth of low-income groups. A pro-cyclical behaviour of the share of lower income groups in overall consumption, but with a downward bias, should be expected under conditions of instability.<sup>13</sup> Thus, instability is a significant source of inequity, and it rewards speculation and windfall gains at the expense of productive activities and TFP.

Real volatility also has an impact on public finances, because during recessions there is a drop in tax proceeds that translates into cuts in expenditure (as happened during the debt, tequila and Asian crises). Maintaining excessive expenditure cuts in essential items for several years undermines efforts to improve factor quality and hinders the full utilization of installed capacity, thus lowering any efficiency of changes in production that might be under way.

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<sup>10</sup> We are assuming that all countries had fairly similarly high rates of utilization of factors in 1980 and 2006, in which case the rise in actual and potential GDP is similar.

<sup>11</sup> The exceptions are Haiti, a country in turmoil as a result of internal conflicts that have conspired against the use of its productive capacity, and Paraguay, where the capital stock series are biased by the construction of huge dams, which has a lagged effect on production. Barring these two cases, the explanatory power of the regression (measured by  $R^2$ ) increases to 92 per cent.

<sup>12</sup> Inequality, in turn, has a negative effect on the formation of human capital, the quality of democracy, and consequently on economic growth (Bourguignon and Walton, 2007; Alesina and Rodrik, 1994).

<sup>13</sup> See, for example, Dutt and Ros, 2005; Lustig, 2000; Morley, 1995; Rodrik, 2001; World Bank, 2003.

The Latin American experience shows that an efficient combination of financial and real macroeconomic balances has been lacking. In the 1990s, successful inflation reduction was partly due, in a number of cases, to exchange-rate appreciations through the so-called *exchange rate anchor*. In fact, the vast majority of Latin American countries revalued their currencies in real terms between 1990 and 1994, between 1995 and 1997, and again between 2004 and 2008. Furthermore, many countries that exhibited high rates of underutilization of their productive capacity, with renewed access to external finance or improved terms of trade, as well as currency revaluations were able to increase their rates of resource utilization while reducing inflation (see white arrows in Figure 1.a, b and c). Supply available in the form of non-exports (GDP not exported) was able to respond rapidly to the increased aggregate demand, with generally falling average rates of inflation. Appreciation-cum-trade liberalization, caused the recovery in aggregate demand, both by individuals and firms, to be increasingly import-intensive (see Ffrench-Davis, 2006, ch. IV). This caused imports to rise to an excessively high level from a level that had been kept low by the previous recession.

In the countries whose currencies had appreciated the most, with bigger and faster growing external deficits led by financial flows, price stabilization tended to be more rapid. However, they also became more vulnerable, as the gap between domestic spending and actual GDP (the external deficit) grew wider and external liabilities rose apace. As was to be expected, external creditors became increasingly sensitive to political and economic “bad news,” which led to broad crises around 1995, 1999 and 2009.

The sharp recovery of GDP growth to 5.3 per cent in 2004–2008 is undoubtedly a positive development, but it took place after six years of large disequilibria (1998–2003), when there was a significant output gap.<sup>14</sup> This long period signifies a costly failure of domestic macroeconomic policies to keeping the economy close to the production frontier. That failure was compounded by the pro-cyclical behaviour of international trade and finance.

## **2. External shocks and real macroeconomic balances**

In order to cope with real volatility it is crucial to understand its causes. External shocks are a major source of macroeconomic fluctuations in EEs. It is possible to identify at least three sources of positive external shocks to which economic activity can respond positively insofar as installed capacity is available. The first source is an increase in export prices. However, swings in external prices are largely transitory; if the economy accommodates to a transitorily high price and abundance of foreign currency, the probable subsequent downward adjustment

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<sup>14</sup> In 2004–2008, pulled up by strengthened world economic activity and sharply improved terms of trade, the output gap fell significantly. While potential GDP was expanding in the order of 3 per cent, actual GDP rose 5.3 per cent in that five-year period. Thus the recessive gap, part of the previous macroeconomic disequilibria, was progressively corrected.

in economic activity usually will be traumatic. A second source of external shocks is changes in international interest rates. These influence the volume of capital inflows, as well as affecting national income – since a drop (rise) in external interest rates increases (reduces) the national income of a net debtor – and the foreign currency market. A third source of external shocks, which has been the main determinant of macroeconomic instability in Latin American countries since the 1970s, is the sharp fluctuations in the volume of capital flows. In this respect, private capital flows other than FDI are particularly noteworthy because of their volatility.

Figure 4 shows the systematic association between swings in aggregate demand and external shocks. In other words, in recent decades, generally real volatility has had an external origin, which has been notably stronger than domestically originated shocks. In the late 1970s and the 1990s there were sizeable capital surges, while recent years have been marked mostly by significant terms-of-trade changes. Figure 5 shows that changes of actual GDP have been sharply associated with fluctuations in aggregate demand. The pro-cyclical external shocks have usually been multiplied by subsequent domestic pro-cyclical policies. In the last four decades, aggregate demand swings have led GDP changes both in the periods of boom and recession that have affected the region. Usually, it is only subsequently that domestic policies have played a role in moderating or exacerbating the effects of external shocks.

#### Figures 4 and 5

In fact, the causality has been twofold. On the one hand, shocks have been essentially exogenous: the overall supply of capital flows, world interest rates, and the evolution of the terms of trade are generally independent of economic policies in EEs. On the other hand, exposure to shocks and the intensity of their effects are affected by some domestic factors. Indeed, the degree to which external shocks are reflected in GDP growth is strongly determined by: (i) the initial gap between actual GDP and the production frontier; (ii) the nature of the domestic economic policies implemented, especially the macroeconomic ones; (iii) the expectations of economic agents; and (iv) political events.

In an “ideal” adjustment process in a perfectly flexible and well-informed economy with *complete* and homogeneous factor markets, excess aggregate demand is eliminated without any drop in the rate of use of capacity. On the other hand, in the typical setting of an economy with price inflexibility and imperfect factor mobility, the implementation of neutral, demand-reducing policies, for instance in the context of a shock in the capital account, usually leads to a significant drop in domestic production. This is because such policies reduce demand for both tradable and non-tradable goods and services, thus giving rise to unemployment especially in the latter sector. This confirms the significant implications of price inflexibility, factor immobility, incomplete markets and

flaws in information during adjustment processes in the real economy. They explain why adjustment usually occurs significantly below the production frontier.

In fact, in adjustment processes in the real world, a sharp reduction of demand tends to cause a decline in production, which gives rise to a lower rate of utilization of installed capacity and discourages capital formation (figure 2). The addition of switching policies that influences the composition of output and expenditure may cushion the decline in economic activity. Such policies may be global – such as the exchange rate – or they may be more sector-specific. The East Asian countries provide examples of the successful use of extremely selective policies, and also of notably effective adjustment processes (Amsden, 2001; Kaplan and Rodrik, 2001; Mahani, Shin and Wang, 2006). Implementing a mix of expenditure-reducing policies and switching policies, which was dismissed by the neoliberal approach, tends to enable a closer to full utilization of potential GDP.

Most crises since the 1980s have been the result of badly managed booms (Ocampo, 2003). In periods of boom, the scope for policy choice is broader, but these are also periods when future imbalances are generated. In order to move towards a macroeconomic environment conducive to growth, there needs to be a systematic, clear distinction between economic recovery and the generation of additional capacity. Failure to differentiate between the two leads not only to public policy neglecting the importance of investment, but also encourages the private sector to undergo a *destabilizing intertemporal adjustment*. Indeed, if a recovery is interpreted as allowing a sustainable growth of potential GDP, supposedly with a high TFP, it can lead to feeling richer and increasing consumption (thus crowding out national savings), while not really being richer. Thus macroeconomic policy should be guided by making a sharp distinction between creating new capacity and using existing capacity.

In fact, if capital inflows or improved terms of trade stimulate processes of recovery in economies that have high unemployment of productive factors, actual productivity rises because of an increase in the rate of utilization of potential GDP. Subsequently, agents and authorities (and also many researchers, e.g. Ffrench-Davis, 2006, ch. III) may confuse the jump in actual productivity that is based on the utilization of previously idle labour and capital with a structural increase in the sustainable speed of productivity improvements. From the point of view of “rational” consumers, they tend to assume that there is an increase in their permanent income. Consequently, the market response would tend to be an intertemporal upward adjustment of consumption, with the external gap covered by capital inflows, as long as the supply of foreign savings is available. That implies a crowding out of domestic savings, which results from agents’ decisions

based on biased information.<sup>15</sup> As a result, the intertemporal adjustment ends up being destabilizing.

The increased availability of funds tends to generate a process of exchange-rate appreciation. And the expectations of continued, persistent appreciation encourage additional inflows from dealers operating with maturity horizons in line with the expected appreciation of the domestic currency. For allocative efficiency and for export-oriented development strategies, a macro price – as significant as the exchange rate – led by capital inflows 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, artificially augments the absorptive capacity and the demand for foreign savings. Thus, exogenous changes (like fluctuations in the supply of funds) are converted into an endogenous process, leading to domestic vulnerability due to the potential reversibility of inflows. In the case of a transitory improvement in the terms of trade, a similar destabilizing process can occur, with an excessive increase in consumption and a weakening in the generation of productive capacity in tradable sectors that are intensive in domestic inputs (i.e. the Dutch disease).

Figure 6 shows that the evolution of real exchange rates has responded to a large extent to financial flows, rather than to the real forces behind the current account. The volatile components of flows have been short-term portfolio investments, while flows of greenfield FDI are fairly stable. In some periods, the mid-term volatility of financial flows has been reinforced by significant fluctuations in the terms of trade. Actually, between 2003 (still a recessive year for Latin America) and 2007 (during a period of significant recovery), the terms of trade explained most of the elimination of the binding external financial restrictions that had kept Latin American countries operating below the production frontier during the period 1998–2003 (see Ocampo, 2007).

Figure 6

Therefore when actual output is reaching close to the production frontier, more active counter-cyclical policies are needed to regulate the expansion of aggregate demand. Moreover, with a closing recessive output gap, the role of policies to enhance productive development (and increase potential output) becomes crucial. In fact, it is essential to keep the rate of expansion of demand in line with the growth of productive capacity (and also with sustainable external financing). Otherwise, if passive macroeconomic policies are adopted in situations of

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<sup>15</sup> As highlighted by Aghion and Durlauf (2009), the low savings ratios underlie the lack of conditional convergence of developing countries, and particularly Latin American countries. We stress that low savings are partly a consequence of recessive gaps led by two-pillar macroeconomics and a subsequent discouragement to productive investment.

positive external shocks (such as lower international interest rates, improved terms of trade, or increased supply of capital inflows) or those of a domestic nature (a boom in the construction sector or in the demand for durable goods or stocks and bonds), then the economy will be subject to inflationary pressures and/or a growing gap between expenditure and output. In all events, a future adjustment in the opposite direction will usually build up.

In brief, it is necessary to further improve the capacity to implement real macroeconomic policies by including a counter-cyclical mix, in order to reconcile the proximity of the economy to the production frontier with sustainability and price stability. However, as documented by Kaminsky et al. (2004) for a sample of 104 countries, the opposite has tended to occur.

### **3. Financial development, financierism and productivism**

Financial development is a key ingredient for economic development.<sup>16</sup> Channelling financial resources to sectors of higher productivity improves overall efficiency in the economy and enhances economic growth. However, financial markets are imperfect and quite incomplete in EEs. In a world of uncertainty, incomplete insurance markets, informational costs and contagious changes of mood, as well as ex ante and ex post valuations of financial assets may be radically different, to the point that market corrections may be abrupt, overshooting and destabilizing (Stiglitz, 2000; 2005).

#### **a) Financierism empowered by neoliberal reforms**

A distinctive feature of macroeconomic management in the transition of the most successful EEs towards the level of development of more advanced countries has been the predominance of *“productivistic”* over *“financieristic”* dimensions. Development has been led by the *“real”* side, with financial aspects at its service. This policy correlation is contrary to the neoliberal approach and to the standard thesis of financial liberalization as one of the most essential inputs for development.

This financieristic neoliberal approach has been adopted by many EEs, with the dominance (or strong influence and powerful lobbying) over macroeconomic decisions of financial agents with a short-term perspective. The growing link with the international financial system facilitated the disassociation with the needs of domestic productive systems and encouraged capital flight during periods of domestic crises. In short, total openness to international financial markets (as witnessed in the 1990s in most EEs) can dismantle comprehensive efforts at domestic stabilization, and tends to lead to integration into more

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<sup>16</sup> See a recent contribution by Aghion and Durlauf, 2009.

speculative segments of world markets. In contrast, insertion into the world economy should be aimed at promoting long-term capital inflows, accompanied by access to technology and export markets.

From the mid-1990s, campaigning and elected Latin American leaders became regular visitors to Wall Street. In addition, when newly elected political authorities had to nominate their economic authorities, the international mass media exerted strong pressures for their preferred candidates – the “market’s candidate”, with “market” denoting the financial markets that have short-term horizons. The strengthening of this dimension has provoked a growing duality, worrisome for democracy, in the constituencies or “voices” taken into account by authorities in EEs. The present features of globalization are increasing the distance between policymakers and financial agents vis-à-vis the domestic agents (workers and firms and fiscal tax proceeds) that are bearing the consequences. Thus, an outcome of the specific road taken by globalization has been that experts in financial intermediation – a microeconomic training – have all too often been a major influence on the evolution of domestic macroeconomic balances and their volatility.<sup>17</sup>

Pressures from international financial markets have pushed some governments to offer guarantees to financial investors as a means of gaining credibility beyond what is consistent with growth and equity, and even beyond what is necessary to achieve short-term credibility with international financial markets. As shown by the Argentinean case in the 1990s, if public commitments go beyond the capacity that a democratic country can bear, the result may be praises in the short term but a net loss of credibility in the medium and long term.

The case of Chile in its return to democracy in 1990 is an outstanding example of differences between the productivist and the financieristic dimensions: while domestic and foreign financial media praised the liberalization policies under the military rule of Pinochet, Chile recorded its lowest investment ratio in the last half of the century. By contrast, the reforms of the 1990s – including regulation of financial inflows, some tax increases, labour reforms to strengthen workers’ bargaining power and significant increases in minimum wages – were initially received with concern and criticism by large private entrepreneurs and the financial sector, while the investment ratio reached historical peaks. This successful combination was made possible by adopting a three-pillar macroeconomic approach in the early 1990s (see Ffrench-Davis, 2010, chapter VIII).

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<sup>17</sup> See interesting comments in Bhagwati (2004) on the lobbying of “Wall Street” financial agents and their negative implications for trade.

## **b) Rational pro-cyclicality of short-term financial markets, and irrational policymakers following their advice**

It becomes highly unlikely to be able to escape from financieristic traps without a traumatic adjustment. Such adjustments usually involve an overshooting to outlier exchange or interest rates and the emergence of considerable liquidity constraints, which together generate a very unfriendly macroeconomic environment for firms and labour.

An outstanding feature of the most recent currency and financial crises in East Asia and Latin America is that they involved mainly those EEs which were considered by IFIs and financial agents as being highly “successful”.<sup>18</sup> Indeed, risk rating agencies had been awarding them with increasingly better grades,<sup>19</sup> as a result of which they attracted large private capital flows and falling spreads, which grew in parallel with accumulating rising stocks of external liabilities.

Given that voluntary flows cannot take place without the willing consent of both debtors and creditors, why did neither agent act in a timely manner to curb flows well before the crises? Both regions had become vulnerable through a combination of large external liabilities with a high short-term or liquid share, credit booms, currency and maturity mismatches, significant external deficits, appreciated exchange rates, high price/earnings ratios in the stock market and high luxury real estate prices, plus low domestic investment ratios in the case of the Latin American countries. In parallel, agents specialized in microeconomic aspects of finance placed in the short-term or liquid segments of capital markets acquired a dominant voice in the generation of macroeconomic expectations. Why are these voices intrinsically pro-cyclical?

There is an extremely relevant body of literature about the causes of financial instability – such as 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) – which underlie the cycles of abundance and shortage of external financing (Krugman, 2000; Rodrik, 1998; Stiglitz, 2000; 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 behaviour and multiple equilibria. Notorious contagion, first of over-optimism and then of over-

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<sup>18</sup> For further details, see Ffrench-Davis, 2006, chapter VI, and Williamson, 2003.

<sup>19</sup> Reisen (2003) points out that risk rating agencies usually follow the market. Nonetheless, they play a significant destabilizing role because they tend to reinforce over-optimism and over-pessimism.

pessimism, has been observed in many of the financial crises experienced by EEs over the last three decades.

During all recent generalized expansive processes, there has been an evident contagion of over-optimism among creditors. Rather than displaying an “appetite for risk”, in those episodes agents supplying funding underestimated or ignored risk. With respect to debtors, in periods of over-optimism, the evidence is that most debtors do not borrow with the idea of a default and expectations of being rescued or benefiting from a moratorium. On the contrary, expectations of high yields tend to prevail: in fact, borrowers are also victims of the syndrome of financial euphoria during boom periods.

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. There are natural asymmetries in the behaviour and objectives of different economic agents. The agents predominant in the financial markets are specialized in short-term liquid investments, operate within short-term horizons, and therefore are highly sensitive to changes in variables that affect returns in the short run.<sup>20</sup> The second feature is the gradual spread of information among prospective agents on investment opportunities in EEs. Agents from different segments of the financial markets gradually become drawn to these economies once they become aware of the new and profitable opportunities available there.

From the supply-side, this explains why the surges of flows to EEs over several periods – 1977–1981, 1991–1994, mid-1995–1998, and 2004–2007 – were *processes* that went on for several years rather than one-shot changes in supply. This points to the relevance for policy design to make a distinction between two different types of volatility of capital flows: short-term ups and downs, and medium-term instability. Medium-term instability causes several variables – such as the stock market, real estate prices and the exchange rate – to move persistently in a given direction, providing “wrong certainties” to the market of one-sided movements of prices and returns. It encourages additional capital flows and the seeking of economic rents, rather than gains due to differentials in real productivity, until it becomes evident that increased prices and returns are not sustainable. Private capital flows, led by mid-term volatility (or reversibility) of expectations, usually have a strong and costly pro-cyclical bias.

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<sup>20</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 boom and bust periods. Pro-cyclicality is reinforced by a trend towards a homogenization of the mood of financial agents (as they converge through herd behaviour). 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 investment portfolios.

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 up in the 1980s and early 1990s, 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, the prices of real estate and equity stocks were extremely depressed and the domestic price of the dollar was comparatively high (ECLAC, 1998; Ffrench-Davis and Ocampo, 2001).

In such a context, there is potentially space for very profitable capital inflows. Flows should continue until rates of return converge, as would happen naturally over the long term. The direction of expected adjustments in any emerging-market economy that moves from a closed to an open capital account under those conditions would tend to be similar to those recorded in Latin American countries. The outcome in these countries as well as in East Asia, for instance, was a spectacular rise in stock prices, multiplying an average price index by four in 1990–1994, and in the Latin American countries, after a sharp 40 percent drop with the Tequila crisis) by two both in 1995–97 in Latin America, and in 1992–1994 in East Asia (Ffrench-Davis 2006, table VII.4). All these swings were directly associated with portfolio flows.

Finally, in an incomplete list, the increased supply of external financing in the 1990s generated a process of exchange rate appreciation in most Latin American countries (see figure 6) and more moderately in East Asia. Consequently, expectations of continued appreciation encouraged additional inflows.<sup>21</sup> However, the combination of an open capital account, large liquid liabilities and expectations of depreciation lead, most naturally, to a large outflow, with a large depreciation if the rate is flexible.

For allocative efficiency and for export-oriented development strategies, a macro price – as significant as the exchange rate – led by capital flows conducted by short-termist agents reveals a strong policy inconsistency. The increase in aggregate demand, driven up by inflows and appreciation, and a rising share of the domestic demand for tradables “artificially” augment a country’s absorptive capacity and the demand for foreign savings. Thus, as mentioned above, the exogenous change – brought about by transformations in international capital

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<sup>21</sup> For short-termist agents, actual and expected profitability increase 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 the exchange rate trend during the expansive or boom stage is most relevant because of its policy implications. It is at this stage that external imbalances and currency and maturity mismatches are, inadvertently, generated.

markets – gets converted into an endogenous process, leading to domestic vulnerability due to the potential reversibility of flows.

In brief, the interaction between the two sets of factors – *the nature of agents* and *the process of adjustment* – explains the dynamics of capital flows over time, and why suppliers keep pouring in funds even when real macroeconomic fundamentals worsen. When creditors *discover* an emerging market, their initial exposure is low or non-existent. Thereafter, they generate a series of consecutive flows, which result in rapidly increasing stocks of financial assets in that market. However, the increase becomes too rapid and/or large for an efficient absorption, and, frequently, the absorption is artificially increased by an exchange-rate appreciation and rising real aggregate demand, resulting in a growing external deficit.

At some point, the creditor's sensitivity to negative news is likely to suddenly increase significantly when the country has reached several *vulnerability zones*. Both the accumulation of stocks of assets abroad by financial suppliers until the boom stage of the cycle is well advanced and a subsequent sudden reversal of flows can be considered as *rational* responses on the part of individual agents with short-term horizons. This is because it is of little concern to this sort of investor whether (long-term) the fundamentals are improving or worsening as long as they continue to bring inflows that continue to generate high earnings for them. What is relevant to them is that the crucial indicators from their point of view (i.e. prices of real estate, bonds and stocks, and exchange rates) can continue to provide them with profits in the near term and, obviously, that liquid markets allow them, if need be, to reverse their decisions in a timely manner. Thus they will continue to supply net inflows until expectations of an imminent reversal build up. This explains why they may suddenly radically change their opinions about the economic situation of a country whose fundamentals, other than liquidity in foreign currency, remain fairly unchanged during a shift from *over-optimism* to *over-pessimism*.

Naturally, the opposite process, of a resumption of inflows, tends to take place when the debtor markets have "sufficiently" adjusted downwards. When this happens, the process of continued inflows can be sustained for some years, as occurred in the periods 1991–1994, 1995–1997 and 2004–2008.

In conclusion, economic agents specialized in the allocation of financial flows, who may be highly efficient in their field but operate with short-term horizons, "by training and by reward", have come to play a leading role in determining macroeconomic conditions and policy design in EEs. This implies that a financieristic approach gains predominance over a productivistic approach. In contrast, growth with equity requires improving the rewards for productivity

enhancement rather than financial rent-seeking in search of capital gains. This calls for a need to rebalance priorities and voices.

#### **4. Concluding remarks**

Emerging-market economies have experienced a sharp paradox: while agreeing on the importance of macroeconomic balances, they have encountered a common situation in which the outcome has been costly disequilibria for large segments of the real economy: labour and physical capital. Indeed, that reveals a severe real macroeconomic disequilibrium.

In order to deal with these inefficiencies, EEs need to adopt a macroeconomic approach that focuses not only on stabilization of the price level and on the control of fiscal deficits (as advocated by the mainstream approach), but also on external balances (key in open economies) and real variables, which affect the link between present and future. Achieving real balance in the use of productive capacity (i.e. the utilization of the productive factors – capital and labour – at their potential level) is crucial to the evolution of actual income, social equity, structural or “full employment”, tax revenues, capital formation and future growth.

Real macroeconomic balances – including aggregate demand that is consistent with productive capacity, sustainable (non-outlier) exchange rates and interest rates, fiscal responsibility and moderate inflation – are essential for growth and equity. Given the pro-cyclicality of financial flows (and terms of trade), one prerequisite for achieving those macroeconomic balances is the comprehensive regulation of capital flows. The positive outcome of such regulation would be a macroeconomic environment conducive to development actually development-friendly. Naturally, for regulating volatile financial flows, developing countries must have several alternatives at their disposal, and be able to choose a flexible set of policies that are strongly counter-cyclical and well adapted to their specific economic structures, the degree of development (completeness) of their markets, and the democratic objectives of their respective societies. In addition, any eventual reform of the international financial architecture must provide sufficient policy space for the needed improvement of macroeconomic policies in emerging-market economies.

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