Integrating uneven partners: the destabilizing effects of financial liberalization and internationalization of Latin American economies

Rogério Studart

RESUMO

Este artigo analiza os fatores de instabilização inerentes à integração de sistemas financeiros de distintos tamanho, profundidade e dinâmica de crescimento, à luz da recente experiência (anos 90) da integração financeira entre América Latina e economias maduras.

Palavras chaves: Integração financeira, fluxos de capital e América Latina.

ABSTRACT

In the last two decades financial integration between Latin American economies and mature economies has been significant and traumatic, as it has been highly associated with macroeconomic instability, poor growth performance and often with domestic financial crises. Some analysts have blamed the volatility of capital flows for such perverse association, while others (mainly mainstream economists) center their criticisms on the inconsistent domestic policies and lack of appropriate financial regulation and supervision in domestic Latin American economies. This paper claims this debate is missing the main issues behind such instability; these are (i) financial integration of Latin American economies in the 1990s has been the "integration of uneven partners", that is the integration of rapidly expanding capital-market based systems with relatively stagnant bank-based systems. (ii) The consequences of such integration is destabilizing due to the volume, type and volatility of capital flows, vis-à-vis the size of and capacity of Latin American domestic financial markets to absorb such flows.

Keywords:financial integration, financial flows and Latin America.

ANPEC: Economia Internacional e Finanças
JEL classification: F36

I. Introduction

In the second half of 1980s and throughout the first half of the 1990s, there was a spectacular growth of financial markets in the developed economies. This growth was soon followed by a significant surge of capital flows from mature economies to developing countries. In special, in Latin America the opening of capital account (in the context of liberalising policies of the end of 1980s and beginning of the 1990s) led to a very significant surge of voluntary foreign capital inflows. These flows had strong destabilising effects on key economic variables, such as exchange rates, domestic supply of credit and domestic asset prices – soon followed by significant macro and financial imbalance. This paper claims that to some this instability was originated by the abrupt and careless integration of two financial markets of quite distinct structure, size, depth and pace of growth. Even though the international financial environment and the policy regimes did have an important role in creating the macro and financial imbalances of the 1990s in Latin America, here we want to focus on the "domestic financial channels" - that is, the links between surges of financial capital in the context of a bank-based financial system with shallow credit and securities markets and of highly unstable growth performance.

The paper is structure in four parts in addition to this introduction. Section II contrasts the distinct structural features and pace of development of financial systems of developed and Latin American economies in the 1980s. Section III presents a theoretical account of the transmission channels of surges of capital inflows into a bank-based developing economy, focusing on the domestic financial channels - on which we want to focus our analysis here. Section IV discusses, in the light of the analysis in the three previous sections, the impacts of the above-mentioned surges on macroeconomic performance and financial stability in the region. Section V summarises our findings and presents our conclusions.

II. Uneven partners

Financial systems in a number of key mature economies (especially the US) changed dramatically in the 1980s and 1990s, as a consequence of domestic deregulation and external financial liberalization. [1] At least four strong trends are observed.

First, a well-known process of desintermediation occurred: the traditional banking institutions were transformed into new financial services firms - including those of institutional securities firms, insurance companies, and asset managers. In addition non-bank financial institutions - such as mutual funds, investment banks, pension funds, and insurance companies – began actively competing with banks both on the asset and liability sides of banks' balance sheets. Second, the deregulation and growth of

[1] For more detailed description of the changes in the financial systems of mature economies, see inter alia BIS (1986), Franklin (1993), Feeney (1994), Helleiner (1994), Bloomenstein (1995) and Group of 10 (2001).

institutional investors – in special pension funds and insurance companies – have made their role in the provision of loanable funds more prominent. Finally external liberalization and significant improvements in information technology have increased across-the-border dealings of securities, and internationalization of the financial business.

The mere fact that new financially "heavy weight" agents (investment banks, mutual funds and institutional investors) were allowed to expand their securities trading led to a rapid growth of prices in the secondary markets. This created a virtuous circle of expansion of asset prices and markets: as financial wealth increased, investors' expectations were fulfilled, leading to further rounds of financial investment. Not surprisingly, the total financial assets in the hands of institutional investors almost tripled from 1987 to 1990, and again almost doubled from 1990 to 1996 (**Table 1**).

Table 1 - Financial assets in the hand of institutional investors in selected OECD economies

Investment companies					Insurance companies				
	1987	1990	1993	1996		1987	1990	1993	1996
USA	770	1069	2075	3539	USA	1095	1900	2422	3052
Japan	305	336	455	420	Japan	271	1067	1620	1956
Gemany	42	72	79	124	Gemany	155	401	452	692
France	204	379	484	529	France	74	239	363	582
United Kingdom	68	89	131	188	United King	190	454	667	792
Other OECD	161	184	517	533	Other OEC	180	565	645	908
Subtotal	1550	2129	3741	5333	Subtotal	1965	4626	6169	7982
Pension Funds					***Total***				
	1987	1990	1993	1996		*1987*	*1990*	*1993*	*1996*
United States	1606	2492	3449	4752	*United Sta*	*3471*	*5461*	*7946*	*11343*
Japan	0	0	0	0	*Japan*	*576*	*1403*	*2075*	*2376*
Gemany	22	52	47	65	*Gemany*	*219*	*525*	*578*	*881*
France	0	0	0	0	*France*	*278*	*618*	*847*	*1111*
United Kingdom	224	537	682	897	*United King*	*482*	*1080*	*1480*	*1877*
Other OECD	287	612	668	886	*Other OEC*	*628*	*1361*	*1830*	*2327*
Subtotal	2139	3693	4846	6600	***TOTAL***	***5654***	***10448***	***14756***	***19915***

Source: BIS (1998: 76-97). Data consolidated by the author.

In addition, evidenced by Fornari and Levy (1999) the gross financial assets of the G6 doubled as a proportion of GDP between 1980 and 1994, whereas the liquidity of these assets increased substantially.[2] Just to give a measure of this trend, from 1989 to 1993, the

[2] This process would probably end up in a tradition Mynskian asset crisis (Minsky, 1982; Taylor and Oconnel, 1985), were it not for the characteristics of the financial markets in some mature economies – in special, the US financial markets. This characteristic has to do with the significant side and depth of securities markets and the strong link between secondary and primary markets. The result of this link was that the growth of capital markets provided new sources of finance to the corporate sector (for instance, the IT sector, "dot.com" companies and so on), a trend that has been highly leveraged by the use of financial derivatives to unbundle risks and securitize. This provided the financing required for the technological revolution and productivity expansion which in turn permitted the astonishing growth of the US "new economy" in the 1990s.

Outstanding amounts of debt securities issued in OECD economies increased over US$ 6 trillion, and more than doubled from 1989 to 2000 (Table 2).

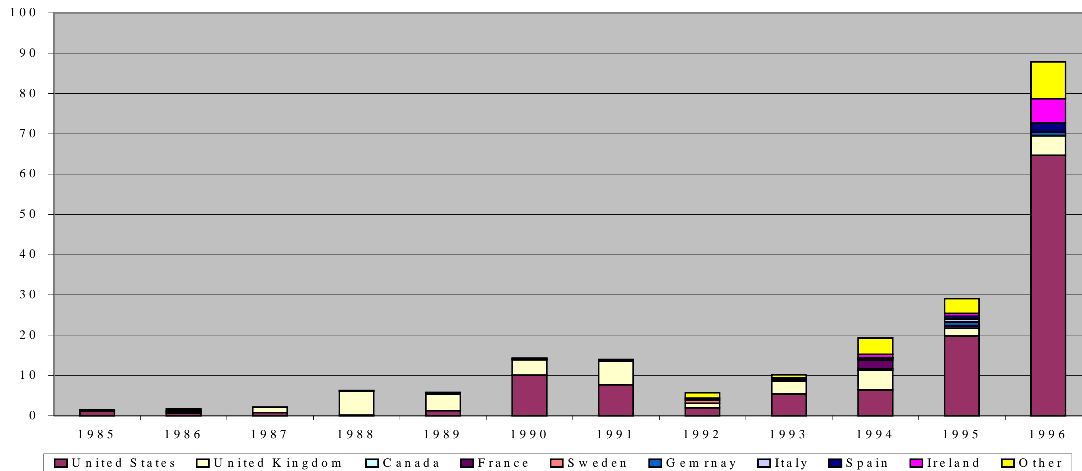
Table 2 - Outstanding amounts of debt securities issued in domestic markets (US$ billions and %)

Year	1989	1993	1997	2000	1989	1993	1997	2000
	US$ Bi				% of total			
All issuers	**14042.4**	**20564.7**	**25464**	**29732.9**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
OECD	***13558.7***	***19966.7***	***24452.4***	***28579.9***	***96.6%***	***97.1%***	***96.0%***	***96.1%***
United States	6682.8	9226.7	12059	14545.9	47.6%	44.9%	47.4%	48.9%
Japan	2626.7	4010.1	4399.3	6072.3	18.7%	19.5%	17.3%	20.4%
France	557.6	995.7	1102.5	1068.1	4.0%	4.8%	4.3%	3.6%
Germany	668.4	1458.4	1732.1	1711.6	4.8%	7.1%	6.8%	5.8%
UK	332.9	446.1	777.7	895.9	2.4%	2.2%	3.1%	3.0%
Latin America	***172.1***	***296.7***	***490.6***	***482.8***	***1.2%***	***1.4%***	***1.9%***	***1.6%***
Argentina	113.5	39	70.1	85.2	0.8%	0.2%	0.3%	0.3%
Brazil	-	189.9	344.5	292.5	-	0.9%	1.4%	1.0%
Chile	7.5	19.2	36.5	34.2	0.1%	0.1%	0.1%	0.1%
Mexico	51.1	47.9	37.6	67.3	0.4%	0.2%	0.1%	0.2%
Peru	-	0.7	1.9	3.6	-	0.0%	0.0%	0.0%

Source: BIS database; consolidated and ellaborated by the author.

The surge of capital flows to developing economies in the 1990s is directly associated with the process described above. First of all, the rapid growth of financial wealth in the hands of private financial investors increased the demand for “risk diversification”. This explains in a great extent the expansion of a variety of specialized securities markets in mature economies - especially in the US -, from investment asset-based securities (for instance, mortgage-based securities) to *junk bonds*. This search for risk diversification also explains a great deal of the expansion of across-the-border securities dealings, and the development of foreign-asset based securities (such as ADRs and GDRs) in the “international” markets - as for instance happened with the asset-based securities issued in securities markets (graph 1).

Graph 1 - Announced asset-backed bonds in the international markets (US$ bi)



Source: BIS (1998: 43).

Similarly to what happened in developed economies, but in a much smaller scale, Latin American financial markets increased substantially in the 1990s - as is evidenced by Table 2 above.

However, in contrast to what happened in developed economies, and like in most developing economies (Beck, Demirgüç-Kunt, Levine and Maksimovic 2000), Latin American financial systems in the early-1990s continue to suffer from the similar structural problems as those described by Raymond Goldsmith (1969) in the 1960s:[3] (a) **the banking sector remained relatively small** (**Graph 1**),[4] lending relatively little and concentrating its operations in short term activities, including the refinancing of government debt, and is highly vulnerable to external shocks; (b) **the supply of loanable funds to specific sectors continued to be highly rationed**.[5] This implies that credit market is *supply-constrained* for many sectors, and these expenditures tend to be highly sensitive to changes in the supply of loanable funds; (c) **net interest margins in the banking sector are still much higher than those found in developed economies (Graph 2)**, an indication of very high *spreads*, leading to non-competitive financial costs to the domestic corporate sectors and high levels of self-finance (which is a deterrent to economic expansion)**;**[6] (d) **securities markets remained small (graph 3)**, and the

[3] As a matter of fact they continue to suffer from these problems to this date.

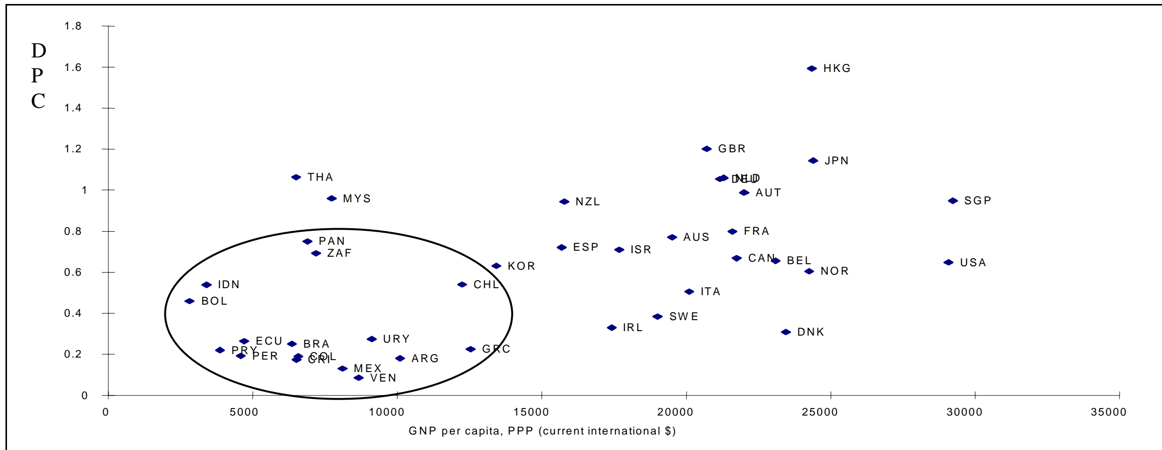
[4] In the graphs below (from 1 to 3) the circles comprise a significant part of Latin American economies of our sample, as an indication of the comparative stage of development of financial systems in the region viz-a-viz mature economies and even some developing economies.

[5] In special to popular house financing, SME and poor consumers and long-term productive investments.

[6] Even though it is possible to reduce such *spreads* through specific policies, as the recent Brazilian experience shows (BCB, 2000), these spreads seem to be highly related to the shallowness of credit markets in developing economies as indicated by Graph 2 below.

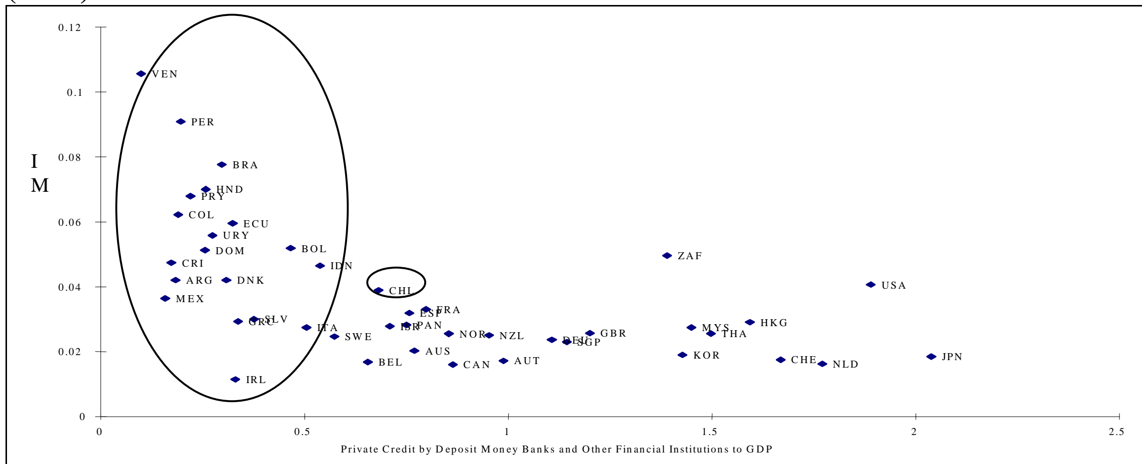
primary markets have actually shrunk in the 1990s, rather than expanded (*Cf.* Dowers et al, 2000).[7]

Graph 1 – Private Credit by Deposit Money Banks to GDP - selected developed and developing economies (1997)



Source: World Bank. Elaborated by the author.
DPC = Private Credit by Deposit Money Banks to GDP.

Graph 2 - Interest rates margins in selected developed and developing economies (1997)



Source: World Bank. Elaborated by the author. IM = Net Interest Margin (%).

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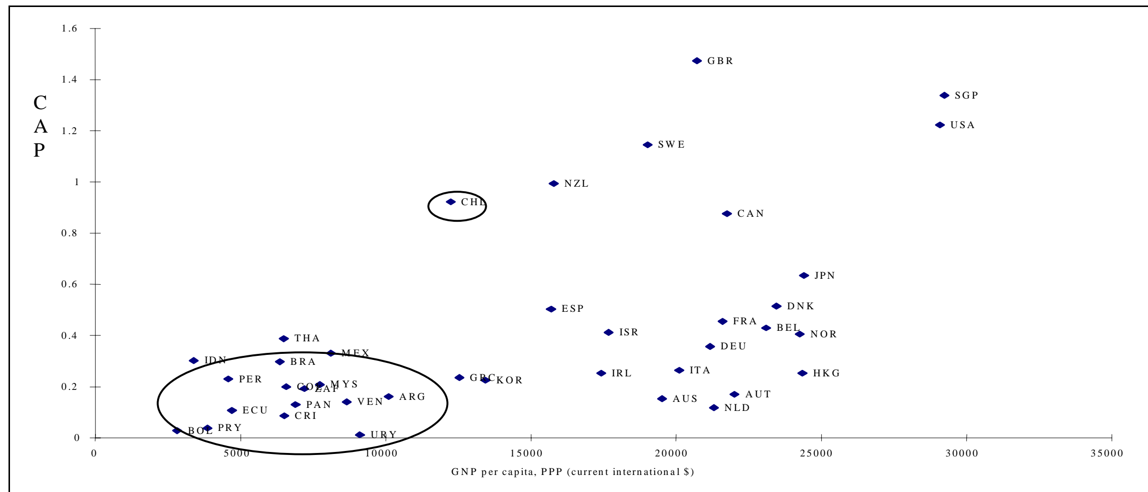
7 In Latin America, the external financial opening and domestic financial deregulation did change some microeconomic structural problems. But the structural problems described above remained (Beck, Demirgüç-Kunt, Levine and Maksimovic 2000). This is not surprising: as discussed in Studart (2000), overcoming these structural problems requires long-term financial and institution-building policies.

Graph 3 – Some indicators of the size of securities in selected developed and developing economies (1997)



Source: World Bank. Elaborated by the author.
CAP = Stock market capitalization to GDP

In the late-1980s Latin American economies opened up their capital accounts and their domestic financial markets to foreign investors. Given the characteristics of Latin American financial systems (vis-à-vis those of the US economies), the microeconomic incentives for portfolio investors in investing in some Latin American financial markets and domestic financial institutions and large corporations issuing became quite significant – as we will see below. This microeconomically rational behavior was, to a great extent, the main source of the process of increasing macro-financial vulnerability and instability in the region in the 1990s.

In order to understand why this integration was destabilizing, we must depict how this surges of capital flows affected key macro and financial variables in Latin American economies. This is our next topic.

III. A stylized transmission mechanism

All developing economies are soft-currency economies,[8] so that it is fair to assume that surges of financial flows affect their performance depending on:

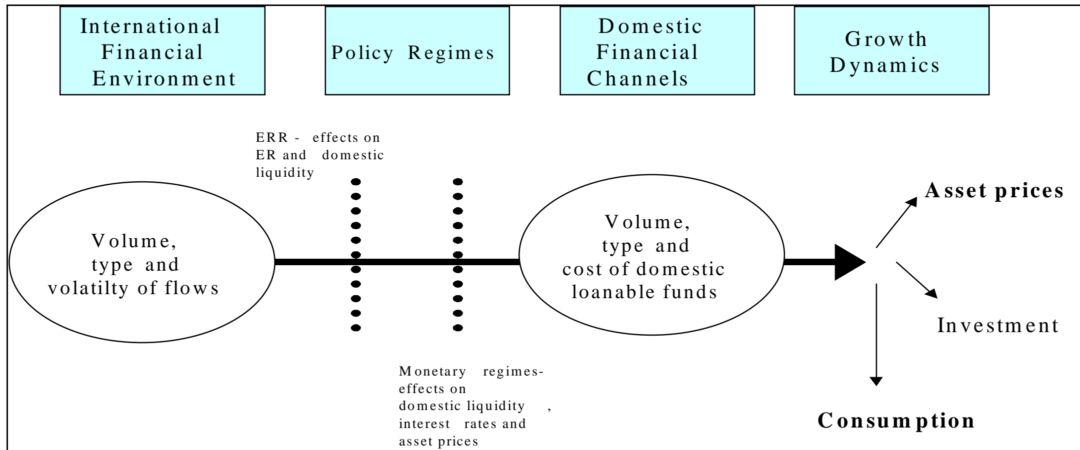
- the international financial environment - the volume of these flows in relation to the size of the economy and their volatility;
- policy regimes - the exchange-rate, trade, monetary and fiscal policy regimes "chosen" by the specific economy;

[8] The fact that some developing economies adopt hard-currencies as their means of payments (such as in the recent processes of dollarization) do not make them "hard-currency economies", due to the fact that their monetary authorities cannot issue the hard-currency adopted. On this see Studart (2001).

- ❖ domestic financial channels:
  - ➢ structure of domestic financial markets - the size, development and depth of domestic financial institutions and markets;
  - ➢ growth dynamics - the domestic dynamics of investment, consumption and government expenditure in the economy.

The diagram below presents a visual guidance to our discussion below.

Diagram 1 - Transmission channels of surges of foreign capital inflows



Source: elaborated by the author.

III.1. International financial environment and policy regime

The **international financial environment** (IFE hereafter) determines the freedom of capital flows between developed and developing economies. In contrast to observed in the post-war period until the 1970s, financial development and internationalizaiton was significant in the 1980s and 1990s. The deregulation of capital accounts in both developed and developing economies allowed for a significant increase of the volume, a diversification of flows (especially in the direction of more portfolio flows) and more mobility (and volatility of these flows) (see e.g. Ocampo 1999). Given the *pull factors* (that is, risk-diversification by investors in mature economies), this opening allowed for a rapid expansion of financial integration.

Given this IFE, the **relative size of capital flows**, *vis-à-vis* the size of the economy matters in fundamental ways. Excessive capital flows (in relation to the needs to finance current account deficits) lead to excess supply of foreign reserves in the economy, which creates pressure either to revaluation of the domestic currency. This excess supply can be measured by the accumulation of reserves during a period of surge of capital inflows. This excess supply has consequences on the real (trade and output) as well as on the financial side (capital account and to the domestic financial markets) of developing economies, contingent on the *policy regimes* in place in the recipient economies.

The size of such flows vis-à-vis the size of host economies and of their domestic financial system determine their capacity of economies to absorb productively such flows. How such "excessive flows" were to affect the domestic economies was very much a result of the *policy regimes* adopted then.

Policy regimes can be seen as the "filters" in the transmission mechanisms of surges of capital inflows. First, the *capital account regime* can partly restrict the volume and the type of flows allowed into the country. Second, *exchange rate regimes* determine how excessive flows of foreign capital are internalised: in a purely floating ERR, the impact of surges would only fall on the exchange rate, that is, the excess would be translated into exchange rate revaluation; whereas in fixed ERR, the surges will result in expansion of domestic liquidity, even if monetary authorities attempt to sterilize it (more on this below). Third, the *trade regime* will determine how the changes of exchange rate will affect the trade balance. Finally, *monetary policy regimes* determine whether domestic monetary authorities will be prepared to sterilize or not the additional liquidity created by a surge of capital flows. If the monetary authorities decide (or are capable[9]) to sterilize, open market operations can maintain interest rates high. It is important to notice though that in that case this will create further incentives for continued capital inflows, as well a put pressure on fiscal balance (more on this below).

There are obviously many combinations of the items above (IFE and policy regimes), so that for the sake of simplicity our theoretical discussion will be based on the characteristic policy and structural environments surrounding Latin American economies in the 1980s and 1990s (when the most recent surge of capital inflows started).

Thus, for a significant number of the economies of the region, the **policy regime** adopted in the early 1990s was a mixture of *highly liberal capital account and trade policies* – with an important exception, that is Chile where some policies towards selective entry of capital were implemented. *Exchange rate policies* were used as anchors for price stabilization policies, whereas the *monetary policy* maintained the differentials between domestic and international interest rates high enough to continue attracting capital flows (and in special portfolio flows). Given the characteristics of the IFE, the policy regimes and the structure of domestic financial systems in Latin American economies, we can go on to analyse the domestic financial channels of surges of capital flows into the region - as we mentioned, the center of our analysis in this paper.

III.2. Domestic financial channels

The shallowness of secondary asset markets in developing economies makes domestic asset markets very sensitive to abrupt changes in liquidity. Unlike what happened in the

[9] In extreme case of fixed ERR, such as the Argentinean currency board, the option to sterilize is limited. In that case, constraining the expansion of liquidity will have to be placed on the domestic banks' capacity to expand credit, for instance through higher reserve requirements. Indeed this was the option taken in the early stages of the Brazilian stabilization plan in 1994.

US economy (as described above), the links between secondary and primary securities markets is weak, so that rapid expansion of the former does not lead necessarily to the expansion of the issues of securities. To the contrary, a rapid growth of the liquidity of these markets tend to become mainly speculative bubbles, which creates disincentives for both issuers and long-term investors to remain in the market.

Further, in the context of rapid financial integration and exchange rate stability, the larger size and greater depth of securities markets in mature economies makes it more attractive for large corporations (exactly those that issue securities in developing economies) to issue abroad. Paradoxically, thus, surges of capital flows in the context of the "integration of uneven partners" tends to exacerbate the speculative nature of securities markets, and to create barriers for the long term development of these markets in developing economies.

A different logic applies to foreign direct investment in the 1990s: most FDI to developing economies has been associated with process of acquisitions of companies in the context of privatisation of public companies and banks. Of course these flows *per se* are only direct to changes of ownership of capital, and do not lead to expansion of aggregate demand. But they do tend to create rapid increases of share prices.

Even though securities markets are small, and their impact can be reduced in affecting expenditure decisions, the burst of speculative bubbles can affect both key domestic financial players and expectations in the economy. In both cases, this can affect macroeconomic performance.

Now, now let us consider flows generated by the domestic banks borrowing in the international market. Due to their balance-sheet structure, banks are usually suppliers of short-term credit. The shallowness of markets for long-term securities and the poor development of interbank deposits markets reduce their capacity to manage their liabilities in order to compensate for changes in their reserves. In these circumstances, banks tend to be very conservative: they tend to lend short, restrict lending to privileged agents (large corporations and governments) and maintain high *spreads*. The access to international markets provides banks with expanded sources of *funding* at low interest rates (vis-à-vis domestic markets) and longer maturities. As long as the exchange rate is perceived as stable (as was the case in most economies in the region in the early-1990s), it is microeconomically rational to borrow long abroad to lend short domestically. Such an increase of external funding increases the domestic competition for expansion of bank loans.

How these surges will affect the macroeconomic performance of the domestic economy will, finally, depend on the **inherited growth dynamics** and the **inherited vulnerability of domestic financial systems**. This are our next topics.

III.2.a. Inherited growth dynamics

The supply and maturities of loanable funds represent a constraint on the expenditure decision of different agents in the economy, being a more determined factor for some (for instance, consumers) than for other (e.g. firms and governments). Surges of financial flows tend to reduce these constraints, as the additional domestic liquidity, created by the domestic intermediation, pushes domestic intermediaries to expand their assets. But final distribution of these loanable funds depends on the dynamics of growth.

In some East Asian economies, for instance, the surge of capital inflows was associated with expansion of investment (see e.g. Park, 1998). This is not at all surprising given that one of the characteristics of the region in the recent past was a sustained growth led by domestic investment and exports and government deficits and debts were relatively small in the early 1990s.

In Latin America, in contrast, investment was depressed during the 1980s, whereas fiscal disequilibria were significant (more on this below). Given the macroeconomic uncertainties and the extent of competitive pressure put on investors, long-term expectations, and thus investment, tended to be highly depressed in the 1990s. As mentioned above, consumer credit in the region, due to the characteristics of the domestic financial structure mentioned below, is highly rationed. In contrast with investment, thus consumption responds rapidly to changes in the supply of credit. Thus in Latin America most of these surges are associated wit "over-consumption", rather than "over-investment".

In addition, given the same uncertainties and other characteristics of the financial sector, and as mentioned above, the intermediation *spreads* of even short term credit tend to be very high, whereas the private supply of long-term loanable funds is simply irrelevant. All these supply and demand factors in the credit market in Latin America, tends to create a significant causal relation between surges of financial flows, credit expansion and domestic consumption boom. These, in turn, affect financial stability, according to the inherited stage of financial fragility –, as we will discuss below.

III.2.b. Inherited financial fragility

First, some words on financial fragility in the context of specific financial structures.

A market economy is characterized by the fact that some expenditures (for instance, the acquisition of durable goods) and long-term uncertain undertakings (fixed capital for instance) need to be financed via the issuance of short-term assets (such as bank deposits) or liquid marketable assets. This combination of uncertainty and maturity mismatching makes our economies inherently a financially fragile economy.

Keynes (1936) rightly noticed that in an economy with developed financial asset markets the changes in expectation of players in financial markets, which can be significant in

periods of uncertainty, could lead to significant changes in the demand for money and interest rates. This in Keynes view could not only create undesirable changes in relative prices of all other assets and goods, but also reduce productive entrepreneurs capacity to repay their debts. Other authors *inter alia* Minsky (e.g. 1982), based on Fisher's (1933) early description of *debt-deflation processes* showed that if monetary authorities did not intervene in this case, this process would lead to decline in output, employment and *bankruptcies*.[10]

Both Keynes and Minsky based their views on a historically specific, anglo-saxon capital market-based financial system. The same rationale can be applied to bank-based systems, of the type observed in Latin American economies, with some *caveats*. First of all, it is bankers' expectations (much more than expectations of traders in securities markets), which are obvious at the centre of changes of supply of liquidity in bank-based systems. This is not the appropriate place to discuss a Keynesian approach to the banking firm,[11] but it can be said is that, given these expectations banks will expand credit according to the supply of reserves available to them.

According to the approach above, *surges of capital flows will affect the financial fragility of a given economy according to the way liquidity is expanded in the process and how this expanded liquidity affects domestic financial flows* - and this has a lot to do with the domestic financial structure. In general, though, periods of surges of capital flows are associated with improved expectations, both of international investors and domestic players, on the future macroeconomic performance of the economy.

It is seemingly rational to assume that bankers' expectations also tend to improve in such a periods. So, not surprisingly, surges of foreign capital flows to Latin America are often associated with the expansion of domestic credit, higher leverage of domestic banks and higher levels of indebtedness by private and public agents. That is, such flows tend to increase domestic financial fragility – as defined above. Fragility does not mean instability: it takes abrupt changes of certain key variables – for instance, an economic downturn, an abrupt change of interest rates and/or of the exchange rates (if the a significant part of domestic liabilities are denominated in foreign currencies) – to turn financial fragility into financial instability.

Given the characteristics of developing markets described above, the policy regimes adopted in Latin America in the 1980s, and the analysis made in the previous paragraph,

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[10] If such a process of *debt-deflation* becomes a self-filling prophecy, it will not be easily reversed by spontaneous means (Taylor and O'Connell, 1985). And it can create a path-dependent process: bankruptcies are irreversible changes, and if their number is significant, potential output is reduced and growth perspectives are lower. Rational long-term investors would hold less confidence in such an economy, leading to lower investment and growth. The expectations that led to the debt-deflation process can become a long, persistent process of stagnation.

[11] On this see Keynes himself (1930, vol. I).

how did large surges of financial flows affect domestic macroeconomic performance and financial stability ? This is the theme of our last topic before the conclusion.

IV. Surges of foreign capital inflows, macroeconomic performance and financial stability

IV.1. Types of flows

As mentioned above, in the first half of the 1990s, there was a spectacular growth of financial markets in the developed economies. This growth was soon followed by a significant surge of capital flows to developing countries – which more than tripled from 1991 to 1995. As indicated by the Table 3, these flows have only been a fraction of those between mature economies, but by all measures are signification vis-à-vis the size of developing economies and their domestic financial markets.[12]

Table 3 - Developing-country shares (percentages except where stated otherwise)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
In global total private capital flows	11.8	12.4	12.6	12.8	12.4	13.2	14.4	9.9	7.6	7.6
In global capital market flows	9.7	9.4	9.4	9	9	9.8	10.8	6.2	4.7	5.5
In global FDI flows	22.3	27.4	29.5	35.2	32.3	34.9	36.5	25.9	18.9	15.9
In global output	19.8	19.2	19.7	20	20.7	22.1	23.2	21.6	21.7	22.5
In global trade	26.5	28.3	28.3	28.4	29.5	31.3	32.4	30.7	30.7	33.4
In global population	84.1	94.3	84.4	84.5	84.6	84.7	84.9	85	85.1	85.2
Memo items (billions of dollars)										
Global capital market flows	794	850	1226	1501	1928	2403	2929	3033	3910	4324
Global FDI	160	172	226	256	331	377	473	683	982	1118

Source: World Bank (2001).

The policy regimes in many Latin American economies had some distinctive features, but were also in a certain way "influenced" by the opportunity offered by such excessive flows. After one decade of balance-of-payments constraints (and net negative resource transfers) leading to very poor macroeconomic performance and high inflation in Latin America, the surge of capital inflows *cum* trade liberalisation eased the external constraint

[12] Even though country-specific features did affect the *distribution* of such flows between developing economies, the *push factors*, related to the changes in financial markets in developed economies, seem to be the most important factor in explaining such growth. This can be seen by the growth of flows to both Latin America and the Caribbean (LAC hereafter) in the 1980s and 1990s, two regions known to have significant macroeconomic performances and that nonetheless had similar trends of capital flows in the 1990s.

for the expansion of domestic demand associated with expanding imports[13] (**Table 4**). In addition, given these exceptional external conditions, many economies in the region used some type of exchange-based price stabilisation programs, based on *pegged exchange rate regimes* and commercial liberalisation, which were effective in reducing inflation.[14]

IV.2. Macroeconomic performance

Using the excessive capital inflows to stabilise prices and to grow had important costs in Latin America in the 1990s. First, in most of the growth dynamics was highly associated with consumption expansion (Chile being one of the very few exception).[15] In contrast, (i) domestic investment remained depressed; (ii) domestic output grew at a lower pace than aggregate demand; (iii) despite the growth of exports, the current account situation continued to deteriorate, due both to the pace of growth of imports and to the increasing external debt. In sum, whereas in the short-medium run external imbalances, and thus external financial dependency, continued to grow, whereas potential output was growing at pace that was lower than needed to solve the macroeconomic imbalances created in the process.

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[13] The surge of capital flows significantly surpassed the needs to finance both the current and the capital account, generating systematic accumulation of reserves in the region.

[14] This is not to deny that other measures were necessary to achieve rapid stabilization. In Argentina, for instance, the Plan de Convertibilidad, which led to the creation of a *currency board* system, was effective in breaking down the inflation dynamics mainly by dollarizing a significant part of spot transactions and forward contracts. In Brazil, with a long history of indexation, breaking up with the inflation dynamics also required a Monetary Reform (implemented in 1994), which had the role of dismantling the main mechanisms of indexation of the economy.

[15] Given the macroeconomic uncertainties and the extent of competitive pressure put on investors, long-term expectations, and thus investment, tended to be highly depressed in the 1990s. As mentioned above, consumer credit in the region, due to the characteristics of the domestic financial structure mentioned below, is highly rationed. In contrast with investment, thus consumption responds rapidly to changes in the supply of credit. Thus in Latin America most of these surges are associated wit “over-consumption”, rather than “over-investment”.

Table 4 - Latin America: some key macroeconomic indicators

	1991	1992	1993	1994	1995	1996	1997	1998	1999
			% changes						
GDP	3,8	3,3	3,9	5,3	1,1	3,6	5,4	2,1	0,4
Per capita GDP	2,0	1,4	2,1	3,5	-0,6	1,9	3,7	0,5	-1,2
CPI a/	199	414	877	333	25,8	18,2	10,4	10,3	9,6
Terms of trade	0,8	-0,6	-0,4	4,9	1,2	1,4	2,0	-5,8	0,4
			%						
Urban unemployment	...	6,5	6,5	6,6	7,5	7,9	7,5	8,1	8,7
			% of GDP b/						
Balance of Payments									
Trade account	0,4	-1,2	-1,5	-1,7	-0,7	-0,5	-1,5	-2,7	-1,1
Current account	-1,5	-2,7	-3,3	-3,3	-2,2	-2,1	-3,3	-4,5	-3,1
Capital and Financial	1,9	3,9	4,4	2,7	1,8	3,7	4,3	3,5	2,8
BOP	0,5	1,2	1,2	-0,6	-0,4	1,6	1,1	-0,9	-0,3
Total disimbursed exte	39,4	37,7	38,1	35,8	37,2	35,5	33,7	37,9	43,4

Source: UN-ECLAC based on official figures..
a/ Dec-Dec. b/ Estimated using current price dollars. c/ including errors and omissions.

As external dependency grew, so did the constraints on domestic policy.

First, in order to maintain the attractiveness for international investors and domestic borrowers, in many economies monetary policies started targeting the maintenance of high interest differentials, whereas fiscal discipline was used as a tool for adding credibility for the stability of exchange rate regimes.[16] Thus, attracting capital flows became a crusade that often included policy package (beyond the exchange rate regime).

Second, the combination of high levels of interest rates made the process of fiscal adjustment difficult and led to loss of international competitiveness of domestic corporations, low levels of economic activity and rising unemployment. Thirdly, increased integration of domestic financial markets with the international ones and the widening of dollar-denominated liabilities and assets: in a significant numbers of the countries, the process of *policy-induced dollarization* was a fact [17]- which has profound effects on financial stability as we will discuss next.

IV.3. Financial fragility

In several occasions in the past (but more obviously in the 1990s), surges of capital flows in Latin America were also associated with domestic financial crises (mainly of the banking sector). These crises in turn prompted policies not only to avoid systemic effects,

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[16] Of course, fiscal discipline was also required for assuring sustainable growth of aggregate demand and supply in a context of low inflation.
[17] There are four ways dollarization could be achieved. For a classification of types of dollarization see Studart (2001).

but also to restructure the domestic banking sector and improve prudential regulation and supervision.[18]

The reasons for these crises vary, but certainly there are some important explaining factor relating to four items.

There was an rise of intermediation risks associated with *exchange rate mismatching*. Rapid financial integration led to *overborrowing syndrome*, to a rapid process of assets and liabilities dollarization and to volatile behaviour of prices of domestic securities and other real assets. The *overborrowing syndrome*[19] leads to increasing vulnerability of domestic borrowers to changes in international interest rates and exchange rates – a vulnerability that is related to the increasing *exchange rate mismatching*.

In the region, such a process took different forms and depth, according to the characteristics of the policy package adopted – but it did happen in a significant number of economies. In Argentina, for instance, there was a rapid increase of dollar-denominated contracts (especially of financial contracts such as consumer and corporate loans) (Studart and Hermann, 2000). In contrast in Brazil, where law forbids contracts denominated in foreign exchange, asset dollarization took mainly the form of dollar-indexed government bonds.[20]

The domestic maturity mismatching increased, due to the way financial flows are internalised into the economies of the region. A significant part of these took the form of portfolio investment, foreign direct investment, issues of corporate and government bonds. But another significant part was intermediated by domestic banks to domestic consumers, which was due to two facts. First, as mentioned earlier, banks tend to be very *short-termist* in the region. Second, the expansion of the supply of loanable funds reached the region in a period of high macroeconomic uncertainty and low investment.

The volatility of prices of domestic assets rose, whereas domestic primary markets shrank. In the region, securities markets, when they exist at all, are quite small and affect only marginally (through the formation of expectations for instance) the macroeconomic performance.[21] However, one important result of the financial integration of the 1990s

[18] This is an important topic for several reasons: first, such processes were often with fiscal costs that made the maintenance of fiscal discipline even tougher; second, because the restructuring of the banking system was normally associated with opening up the domestic financial sector to foreign investors; third, because these regulatory and supervisory changes are affecting the way banks and other financial institutions intermediate loanable funds in the economy - a factor that is important for long term growth perspectives of some of the economies. These topics go far beyond the scope of these papers, but see, for instance, Stallings and Studart (2001) for a discussion of theme.

[19] That is, the expansion of external debt in excess of the needs to finance current account deficits leading to accumulation of reserves in periods of surges of financial flows to the region.

[20]For an analysis of the process of liability dollarization in the MERCOSUR region, see Studart and Hermmann (2000).

[21] An important exception is the Brazilian case, as is evidenced by Studart (2000).

was the shrinkage of primary markets, associated both with the delisting of large companies and their option to issue securities abroad (Dowers et al, 2000). This is likely to create further problems of investment finance, and thus growht in the long run.

Exchange rate crises have become more frequent, often associated with rapid devaluation and/or interest rate hike. In the context of high maturity and exchange rate mismatching and/or increased supply of credit, raising the domestic interest rates or devaluing exchange rates is a recipe for financial instability. And indeed there were many occasions when both had to be done in view of abrupt reversals of foreign capital flows. Indeed, in many economies of the region, banking crises were often associated with such reversals.

IV.4. Recent developments and a inheritance of the integration among uneven partners

In the first half of the 1990s the combination of stable (and sometimes overvalued) exchange rates, commercial opening and financial opening, and fiscal discipline led to a virtuous circle leading where the rapid achievement of price stability and exchange rate overvaluation further attracted foreign capital inflows.

The virtuosity of this circle proved however to be a double two-edged sword in the second half of the 1990s, a feature that was already signalled by the 1994 Mexican crisis and the *Tequila* contagion effect. From that experience, it was already clear that the macroeconomic the economies in the region were too much dependent on foreign financial inflows and thus on the *moods* of international financial investors. However, the prompt recovery of the flows to Latin American economies reduced the overall concerns, and very few voices were heard against the continuing process of external fragilization that was in course in the region.

From the eruption of the East Asian crisis in 1998, the deterioration of the confidence of foreign investors was reflected in increasing country risk implicit in the need to maintain even higher levels of interest rates. This in turn led to the widening financial disequilibria in domestic public and private sectors, while the disequilibria of the trade and services accounts of the balance of payments persisted.

Ultimately the growing emerging-market crisis hit the LAC region, beginning with the contagion of the East Asian financial crisis and culminated with the 1999 speculative attack on Brazil - an attack that led (initially) to a chaotic process of devaluation of the Brazilian *Real*. The pressures on Brazil ceded and the price and output effects were far less drastic than expected (by the most optimistic analysts). Nevertheless the devaluation of the *Real* brought a severe misalignment of exchange rates in some important partners of Brazil in the region, especially those in the MERCOSUL bloc. As occurred in East Asia, the pressures for competitive exchange devaluation became significant and further increased the policy constraints and challenges faced by the region now.

A process of competitive devaluation *per se* can have drastic effects on domestic prices and output - as the experience in Europe in the 1970s-1980s and, more recently in East Asia indicate. In economies with low levels of domestic asset and liability dollarization,

these effects tend to diminish with time, as real exchange levels are established around their equilibrium levels. However, due to the degree of *dollarization* of domestic assets and liabilities in countries such as Argentina, Paraguay and Uruguay - just to mention a few – devaluation tend to have further consequences to their domestic financial systems. And financial instability, as is well documented, tends to have long-term negative effects on macroeconomic performance.

V. Concluding remarks

The nature and the transmission of surges of foreign financial flows seem to have become quite different since the 1980s. Financial globalization does not only mean an increase of financial flows between developed and developing economies, but also a deeper financial linkages between economic agents of these economies.

If our reasoning is correct, this integration is inherently destabilizing due to the wide (and widening) differences between ffinancial markets in mature and developing economies. Domestic policies in developing countries can mitigate, but not avoid these destabilizing effects. At least four complementing strategies need to be implemented in order to avoid that surges of financial flows (and abrupt reversals of these flows) affect the macroeconomic performance and the financial stability in the region.

First, a better International Financial Architecture (IFA) is badly needed. Most proposals in this areas focus on the need for improved transparency and information, better domestic and international regulation, increased provision of official liquidity in times of crises and more private sector involvement in preventing and resolving crises. Most of these proposals lead, at the end of the day, to the reduction of the incentives for abrupt shifts of capital flows and the mitigation of their effects on developing economies, and to incentives towards increased flows of productive capital into the latter.[22]

Second, until such a more stabilizing IFA is not built, Latin American economies should be able to "shelter" their economies from destabilizing effects of short-term volatile capital inflows. The major problem about imposing capital controls is that if this is a long-term policy it tends to affect flows of productive capital (FDI) (on this see Ocampo, 1999). In this sense, this policy cannot be but a medium term one, in order to buy time for the development of mechanisms which make such short-term capital less harmful and even less necessary (on the need of capital controls, see *inter alia,* Ffrench-Davis, 1999 and Griffith-Jones & Kimmis, J., 1998).

Third, even if the conditions above are met, given the size and volatility of international financial flows, the maintenance of an autonomous monetary policy can be more of an

[22] Detailed analysis and proposals concerning this new international financial architecture can be found *interalia* in Ocampo (1999), United Nations Task Force (1999), Fischer (1999) and Griffith-Jones et al (1999).

asset than a liability. And in this case, a more flexible ERR is preferred to a less flexible one. *Choosing an ERR that permits active use of stabilizing monetary policy*. If our analysis is correct, a stabilizing monetary policy is required in order to avoid financial instability and to provide lender-of-last resort facilities for domestic banking system. In addition, as shown above, an active monetary policy is required if the rate of growth of developing economies is to be greater that that of developed economies – a requirement that few economists would doubt. Choosing an ERR that inhibits and surrenders policy autonomy in this case may be both counterproductive in terms of avoiding financial stability and in terms of making growth potential effective.

Finally, developing countries should make efforts in the long run to develop financial mechanisms to internally *finance* and *fund* production, consumption and investment. The question of financial development cannot be treated in this paper, much less in a conclusion. We would report the reader to some recent literature on this issue, including the *World Economic and Social Survey 1999* (United Nations, 1999) – which in addition to an updated bibliography on the theme has important policy conclusions. Studart (1999) analyses the link between the growth of institutional investors within developing economies.

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