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Its Implications for Macroeconomic Policy**

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BALANCE OF PAYMENTS DOMINANCE: ITS IMPLICATIONS FOR MACROECONOMIC POLICY

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Abstract

This paper defines “balance of payments dominance” as a macroeconomic regime in which the short-term macroeconomic dynamics is essentially determined by external shocks, positive or negative. It argues that this is the predominant regime in emerging and developing countries. Trade shocks play an important role but the major cyclical shocks are associated with boom-bust cycles in external financing. Policy challenges are associated not only with the management of such shocks but also with the need to enhance the space for countercyclical macroeconomic policies, as boom-bust cycles tend to pressure macroeconomic policies to behave in a procyclical way. Under these conditions, the best bet is to design policies to reduce *external* vulnerabilities through a mix of administered exchange rate flexibility, very active foreign exchange reserve management, reduced reliance on external borrowing, and macroprudential regulations, including those directly affecting capital flows. Countercyclical fiscal policy can also play a role but faces strong economic and political economy challenges.

A major theme of structuralist economics has been the central role that the balance of payments plays in macroeconomic dynamics (Ocampo, Rada and Taylor, 2009). The emphasis on the implications of “external gaps” and the “Dutch disease” for growth in developing countries are part of that tradition. However, in this paper I will refer to a different phenomenon: the heavy influence that the balance of payments exercises on the *short-term* macroeconomic dynamics in developing countries –i.e., the dependence of domestic business cycles on external shocks, positive and negative, that are transmitted through the balance of payments. One of the major features of this dependence is that it also generates strong pressures for macroeconomic policy to behave

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in a procyclical way.¹ Some of these shocks may be massive and change the long-term trajectory of economic growth; if that case, however, they may be understood as structural external gaps.

The close link between external and domestic business cycles in developing countries has old roots. It was evident during the days of the gold (and silver) standard, when countries of the periphery were frequently forced to abandon it during crises. However, the aim was always to return to such standards and the associated “rules of the game”, which essentially meant procyclical macroeconomic policies. The final collapse of the gold standard during Great Depression represented a huge paradigm change, as Keynesian policy shifted the attention of macroeconomics to countercyclical policies. However, while the center of attention of such policies in the industrial countries came to be the management of aggregate *demand* through active fiscal and monetary policies, the predominance of external shocks implied that the focus of countercyclical management in developing countries came to be the management of the *supply* shocks –i.e., constraints on domestic economic activity²— associated with the availability of foreign exchange.

The mainstream literature has called “fiscal dominance” a regime in which macroeconomic management is essentially determined by fiscal conditions. So, I will call “balance of payments dominance” the regime in which the external shocks, positive and negative, are the essential determinant of *short-term* macroeconomic dynamics. Under

¹ I will refer to the shocks generated through the trade or capital account as simply *cyclical* shocks, but to their *effects* on domestic private or public-sector spending as *procyclical* if they transmit or reinforce the direction of the external shocks. Equally, we would refer to procyclical policies when those policies reinforce the direction of the shocks. In either case, they would be countercyclical when they counteract the direction of the shock.

² These supply shocks, which affect domestic economic activity through the scarcity of foreign exchange (i.e., make aggregate supply depend on the availability of foreign exchange and not on production capacity), should be differentiated from those that affect the price level, to which I will also refer below.

this regime, the balance of payments exercises strong *cyclical* shocks, through trade and the availability and costs of external financing.³ The latter include movements in risk spreads (reductions during booms, increases during crises) that reinforce the cyclical effects in the availability of finance and may generate procyclical variations of domestic interest rates. In turn, both the trade and the capital account tend to generate cyclical effects on exchange rates (appreciation during booms, depreciation during crises) that have more ambiguous effects. Under these interest and exchange rate pressures, macroeconomic authorities have to fight hard to build the space for effective countercyclical macroeconomic policies.

It is thus not surprising that in the old days of state-led industrialization in the developing world (or import-substituting industrialization, as it is more commonly called), the major instruments of macroeconomic policy focused on managing external shocks, mainly those coming through the trade account but, since the 1970s, also from the capital account. The interventionist apparatus included an array of instruments of protection and export promotion, capital controls, multiple exchange rates (particularly in the early years) and since the 1960s the crawling peg, a major Latin American innovation to manage the exchange rates in inflation-prone economies (Frenkel and Rapetti, 2011). Most of these instruments were dismantled during the process of economic liberalization. The major one left was the exchange rate, which was made increasingly flexible to accommodate the external shocks that came through the capital account. In several cases, the exchange rate was used to manage domestic policy objectives, particularly, to

³ For some countries, variations in the flows of remittances from migrant workers may also be important.

“anchor” the price level in anti-inflationary programs, in which case it was not even allowed to be an active instrument to manage balance of payments shocks.

This paper will explore the nature and modalities of countercyclical macroeconomic policies under balance of payments dominance. In the next section, I deal with the contemporary modalities of this dominance. Then I discuss countercyclical fiscal policies and the space for monetary and exchange rate autonomy in economies subject to such regime. Given the particular expertise of the author, the paper is mixed with references to the Latin American experience.

The contemporary modalities of balance of payments dominance

International trade continues to generate cyclical shocks in developing countries.⁴ This is particularly true of terms of trade variations in commodity dependent economies. The recent global financial crisis also showed, indeed in a dramatic way, how the economies specializing in manufacturing and services can be subject to strong cyclical external demand shocks.

However, the dominant feature since the mid-1970s has been the central role that the *capital* account plays in generating cyclical shocks for those developing countries that have access to private capital markets. Furthermore, whereas fiscal accounts played a central role in the first contemporary cycle of external financing (from the mid-1970s through the traumatic 1980s), the dominant feature in recent decades has been the predominance of external private financing and the procyclical effect they have on

⁴ Under this heading, I include the so-called “emerging economies”, a category that has an unclear definition but will be understood here as the increasing number of developing countries that have access to global private capital markets.

private sector spending and balance sheets. One of its manifestations has been the frequency of “twin” domestic banking and external crises since the early 1980s, with the liberalizing Southern Cone countries of South America as pioneers in this field.

This phenomenon is, of course, part of the basic tendency of private finance to experience boom-bust cycles, a theme that was central to the Keynesian revolution and was developed with particular brilliance by Minsky (1982). Confirmation of this pattern is provided, among others, in the classic analysis of Kindleberger (see Kindleberger and Aliber, 2005), the most recent by Reinhart and Rogoff (2009), in relation to emerging economies by Akyüz (2011) and to Latin America by Ffrench-Davis and Griffith-Jones (2011). Through the business cycle, private agents alternate between “risk appetite” (or, rather, underestimation of risks) and “flight to quality” (risk aversion), to use typical terms of the financial parlance. In the case of non-residents this is reflected in the finance they provide to domestic agents; in the latter, it is reflected in the alternation in the relative demand for assets denominated in domestic vs. foreign currencies, which generate a repatriation of capital during booms followed by capital flight during crises. In turn, opinions and expectations of different agents feed back into each other, generating an alternation of contagion of optimism and pessimism. Asymmetries of information typical of financial markets, risk evaluation models and certain market practices (benchmarking with competitors) tend to accentuate these trends.

Boom-bust cycles are stronger for those agents that are considered riskier by financial markets, who experience easier availability of finance during booms followed by credit rationing and/or high costs of financing during crises. This is the situation faced by small enterprises and lower income households even in mature industrial markets. It is

also the condition of emerging and developing countries during crises (including peripheral Europe during the current crisis). One way of understanding this phenomenon is that financial integration by developing countries into the global financial market is a segmented integration (Frenkel, 2008) –i.e., integration into a market that is segmented by risk categories, with those considered riskier being subject to deeper boom-bust cycles. As a result, emerging economies experience boom-bust cycles independently of their macroeconomic fundamentals (Calvo and Talvi, 2008). Countries that are considered “successful” are inevitably brought into the boom, but this can lead to the accumulation of vulnerabilities that may lead them to crises; if so, they may later turn into pariahs of the global financial world (Ffrench-Davis, 2001; Marfán, 2005).

Volatility is reflected in the behavior of spreads as well as in the availability and maturity of financing. Risks tend to be more pronounced in developing countries due the proliferation of maturity and currency mismatches in private sector balance sheets. All forms of financing tend to be cyclical, but this pattern is sharper for short-term financing, which thus tends to be particularly risky (Rodrik and Velasco, 2000). A recent diagnosis by the IMF (2011, ch. 4) indicate that the volatility of capital flows has increased over time and is sharper for emerging than for advanced economies. Bank and other capital flows are more volatile, followed by portfolio debt flows, but FDI volatility has increased and is now similar to that for portfolio debt flows. In turn, persistence is lowest for portfolio debt flows, and has declined for FDI since 2000. In the case of FDI, increasing volatility and lack of persistence may reflect the fact that financial FDI (i.e., borrowing by subsidiary from a parent bank or firm) has increased over time.

Intense short-term movements, such as those produced after the August 1998 Russian moratoria and the September 2008 collapse of Lehman Brothers, are particularly traumatic. However, in practice the most difficult phenomena to manage in macroeconomic terms are *medium-term* cycles –i.e., those that have tended to last 7 to 15 years. Developing countries have experienced three such cycles since the 1970s and are at the beginning of a fourth one: a boom in the second half of the 1970s followed by a collapse in the 1980s; a boom in 1990-97 (shortly interrupted by the December 1994 Mexican crisis) followed by the sequence of emerging market crises that started in East Asia in mid-1997; a new boom between 2003 and mid-2008 followed by the global effects of the collapse of Lehman Brothers; and a new boom since mid-2009, shortly interrupted by events around the world, particularly by the different episodes of the euro crisis.

Historical evidence seems to indicate that the strength of the policies adopted by advanced economies to stabilize financial markets is critical for the length of the downward phase of the cycle. So, the massive interventions after the collapse of Lehman brothers were critical for the return to more normal financial conditions in the developing world in a relatively short time period (about a year). The same is true of massive support to Mexico after its December 1994 crisis (a few months). In contrast, weak and delayed action after the August 1982 Mexican moratoria and the first stages of the East Asian crisis in the second semester of 1997 led to protracted crises in emerging markets (eight and six years, respectively).

Another factor that has mitigated the strength and length of crises is the reduced *external* vulnerability of developing countries generated by the combination of massive

self-insurance through foreign reserve accumulation and the development of domestic bond markets after the Asian financial crisis, which made governments less dependent on external financing. Both led to the reduced perception of risk, reflected in the low spreads between 2004 and 2007. Although this may be understood as a reflection of reduced financial market segmentation, the fact that its counterpart is massive self-insurance indicates that market segmentation is still a feature of the global economy, but one that can be mitigated by prudential policies.

As indicated, the major problems generated by boom-bust cycles are associated with procyclical private sector spending and induced vulnerabilities in balance sheets. However, the major complication is that this is accompanied by the reduced space for traditional countercyclical policies. Given this constraint, the key to appropriate countercyclical management is the expanded availability of policy instruments to manage the domestic effects of external boom-bust cycles. This is particularly so when we understand that stability goes beyond price stability and includes *real* and *financial* stability –i.e., avoiding sharp business cycles and domestic financial crises.

This indicates the need to continue reflecting on the design of countercyclical policies appropriate for economies facing balance of payments dominance. In the rest of the paper I explore three broad set of policies and their capacity to smooth the business cycle: fiscal policies; monetary and exchange rate policies (that due to their linkages must be analyzed simultaneously), and what Epstein *et al.* (2003) and Ocampo (2008) have called capital management techniques, which using the terminology *en vogue* will be called macroprudential policies.

Countercyclical fiscal policies

Fiscal policy can always play a useful countercyclical role, but it faces strong demands to operate in the opposite way due to the pressures from financial markets and political economy considerations. In countries where commodity prices are an essential source of public sector revenues, one of the best alternatives is to create commodity stabilization funds. Important examples in Latin America are the National Coffee Fund of Colombia (which, however, largely abandoned its stabilization function in the 1990s) and the Chilean copper stabilization funds, but this instrument has spread worldwide, in particular in mineral and oil-exporting economies. Based on this experience, ECLAC (1998) proposed creating general stabilization funds for public sector revenues which would absorb the transitory component of such revenues.

This should be accompanied by the creation of structural rules for public sector financing, a step taken a decade ago by Chile and most recently replicated by Colombia. This is, of course, no easy task, as GDP trends may not be independent from cyclical fluctuations, particularly in economies experiencing sharp business cycles (Heyman, 2000) and in commodity dependent economies because commodity prices may be subject to short-term fluctuations that may lead to changes in trends. In any case, what the structural rules imply is that public sector finances must be guided by long-term trends. Strictly speaking, what this means is that fiscal policy becomes *neutral* over the business cycle (i.e., *a*-cyclical), implying that it has to be complemented by strictly countercyclical

instruments.⁵ However, to avoid lags in the countercyclical effects of fiscal policy, the best are automatic stabilizers associated with tax and spending policies.

In this regard, the experience of industrial economies is that the best automatic spending stabilizers are those associated with social protection systems, particularly unemployment insurance. The latter may not be the appropriate instrument in developing countries, where informal jobs play an important role in employment generation. Some additional instruments may be needed, particularly emergency employment programs that are automatically triggered during crises. Conditional cash transfers were also used during the recent crisis for this purpose in several countries; however, as it is hard to reduce them during upswings, they cannot be used as a permanent countercyclical tool.

Tax instruments can also play the role of automatic stabilizers. The best case is, of course, a progressive income tax. However, other tax instruments can be useful for that purpose. This is the case of instruments to capture windfall price gains in natural resource exports that are absorbed through the aforementioned commodity stabilization funds. A similar argument can be made for taxing capital inflows during capital account booms. Note that this is a *fiscal* argument for the use of this tax, and thus different from those that will be discussed in the next section, which relate to monetary and foreign exchange management. With a similar logic, a countercyclical VAT could be designed. An alternative used by some countries during the recent crisis was to temporarily reduce some VAT rates to encourage spending.

⁵ This is what Ffrench-Davis (2010) has argued in relation to the Chilean fiscal funds.

Countercyclical fiscal purposes face, in any case, some constraints, of both economic and political economy character. In economic terms, the major problem is lack of access to appropriate financing during crises, as well as the pressure from markets (and possibly the IMF) to adopt austerity policies to generate “credibility” –particularly, reduce the perceived risk of default. However, if authorities adopt austerity policies during crises, it would be politically impossible to justify maintaining those policies during booms. Thus, austerity during crises generates a vicious circle that leads to the pressure to spend during the succeeding boom, thus generating a procyclical fiscal policy.

In turn, during booms, it is difficult in political terms to justify fiscal austerity to compensate for the “exuberance” of private sector spending (Marfán, 2005). This is particularly true if the spending boom benefits high income groups, whereas cuts in public sector spending affect lower income recipients, as countercyclical fiscal policy would thus be regarded as regressive in distributive terms. There may be also classical time inconsistency issues. Particularly, savings during booms may generate pressure to spend them (the pressure Chile faced during the 2003-08 boom) or to dilapidate them in the form of unsustainable tax cuts (what the US did after the Clinton era).

Countercyclical fiscal policy can also generate some inefficiencies in public sector spending (for example, interruptions in public sector investment projects that increase their costs) or long-term inflexibilities (additional social spending during crises that becomes permanent). Furthermore, in political terms, it may be difficult to design countercyclical tax instruments, as reflected in the opposition of commodity exporters to taxes that capture their windfall gains.

For all these reasons, countercyclical fiscal policies are the exception rather than the rule in the developing world. The analysis of cyclical patterns of spending in over 100 countries during 1960-2003 by Kamisky *et al.* (2004) indicates, in fact, that fiscal policies tend to be procyclical in developing countries, particularly in Africa and Latin America, in contrast to the experience of the industrial world. Using these results, Ocampo and Vos (2008, ch. IV) showed that this behavior is associated with lower long-term growth. For Latin America, Martner and Tromben (2003) come to similar conclusions regarding the dominance of procyclical fiscal in Latin America in 1990-2001 and Bello and Jiménez (2008) for 1990-2006.

Contrary to a common perception, this continued to be the case in Latin America during the recent cycle (the 2003-2008 boom and the 2009 crisis).⁶ Procyclical policies were the rule in most countries, and a few showed persistent expansionary spending policies, which implied that they were procyclical during the boom, but in a sense turned countercyclical during the crisis. Strict countercyclical policies were followed by only a handful of countries. In fact, a good description of Latin American fiscal patterns over the last two cycles is one in which spending respond with lags to revenues through the business cycle (Ocampo, 2011a). So, spending was moderate during the initial phases of the recent boom but turned very expansionary at the end (2006-08) –i.e., became highly procyclical. This spending dynamics was maintained during 2009, thus generating some countercyclical effects. The return to greater austerity in 2010 was the result of the lagged response to lower revenues, but generated a countercyclical effect given the speedy recovery that took place.

⁶ See, among others, IDB (2008) and Ocampo (2009) for the boom, and IMF (2010, ch. 4) and Ocampo (2011a) for the recent cycle as a whole.

Monetary and exchange rate autonomy under balance of payments dominance

In recent decades, the global economy is full of examples of the strong procyclical pressures that boom-bust cycles in global capital markets exercise on monetary and exchange rate policies in developing and, particularly, emerging economies. This is particularly true of monetary policy in economies that have opened their capital accounts, and that face strong pressures to reduce interest rates during booms and increase them during crises, following trends in international capital markets. If authorities try to counteract these pressures and manage monetary policy in a countercyclical way, they simply displace the effect towards the foreign exchange market –i.e., they speed up appreciation pressures during booms and depreciation pressures during crises. What this means is that authorities in fact lack policy autonomy and can only choose what procyclical effect from global capital markets they prefer.⁷ This statement must be read in a nuanced way but captures a significant grain of truth.

The effects of exchange rate fluctuations are the most complex, as they generate ambiguous short-term effects, though clearly counterproductive long-term impacts. The major countercyclical effect operates through the current account of the balance of payments: exchange rate appreciation during booms leads to a deterioration of the current account, whereas depreciation during crisis leads to an improvement in that account, both generate variations in net exports that help stabilize domestic aggregate demand. However, beyond certain level, these countercyclical effects are actually counterproductive, as there is broad evidence that deterioration in the current account

⁷ There is some similarity here with the view of Robert Mundell regarding monetary policies under a fixed exchange rate regime. According to his now classical view, authorities do not determine the money supply but can change the composition of domestic and foreign exchange assets that the central bank holds.

during booms has been a common source of crises: it helps to “absorb” the excess supply of external financing during booms but turns into the major source vulnerability during crises when capital stops flowing in. In turn, the associated exchange rate volatility generates unstable incentives to invest in the production of tradable goods and services,⁸ which are particularly counterproductive in terms of the diversification of the export base. For these reasons, structuralist macroeconomics has taken a negative view of this countercyclical effect of exchange rate movements.⁹

Furthermore, these effects tend to be frequently weaker than the procyclical effects that exchange rate fluctuations also generate, through two different channels, and that explain the ambiguous effects that exchange rate fluctuations have over aggregate demand through the business cycle. The first and most important are the effects that exchange rate fluctuations have on private sector balance sheets in economies where the private sector is a net borrower in international capital markets.¹⁰ In this case, appreciation during booms generates capital gains that tend to increase aggregate demand, whereas depreciation during crises generates capital losses and recessionary effects. The second effect is distributive in character and has been one the major focus of the traditional literature on the contractionary effects of devaluation (Diaz-Alejandro, 1988, ch. 1; Krugman and Taylor, 1978). The simplest way of visualizing them is through the effects of the exchange rate on real wages: appreciation tends to increase real wages,

⁸ This is, of course, the case, only if investors are risk averse, but I take this to be the general case.

⁹ See, for example, Frenkel (2007), Ocampo (2003 and 2008), Ocampo, Rada and Taylor (2009) and Stiglitz *et al.* (2006).

¹⁰ This may also be true of public sector balance sheets, but those effects can be accommodated in a properly designed countercyclical fiscal policy.

thus generating an expansionary effect if there is a high propensity to consume wage incomes, whereas depreciation during crises generates the opposite effect during crises.

The macroeconomic literature has captured the constraints that authorities face through what has come to be known as the “trilemma” of open economies. Its most important implication is that in countries where the capital account has been opened up, authorities can control the exchange rate or the interest rate, but not both of them. Prior to the crisis, this led several economists to argue that there is a need for “credible” exchange rate regimes, which in their view should either be entirely flexible exchange rates—in which they maintain monetary policy autonomy but give up the management of exchange rates altogether—or “hard” pegs. In the latter case, they really give up *both* monetary and exchange rate autonomy; indeed creating the modern counterpart of the procyclical “rules of the game” of the gold standard.¹¹ The system is meant to avoid the destabilizing speculative flows typical of fixed but adjustable rates. However, from historical experience, we know that such destabilizing flows may not be absent and indeed that the collapse of such regimes is chaotic, as it was shown by the crumbling of the gold standard during the 1930s, and by the disorderly breakdown of the Argentinean convertibility regime in the early 2000s.

In contrast, the choice of flexible exchange rates with monetary policies aimed at meeting inflation targets has some countercyclical virtues. Nonetheless, this is true if and

¹¹ This may be said to have affected the European periphery during the recent crisis, but in the case of the peripheral countries that are in the euro area it really reflects the unwillingness of the European Central Bank (ECB) to exercise its countercyclical role, in particular to counteract the increases in risk spreads in those countries generated by private capital markets. The ECB has referred to this phenomenon as imperfections in the transmission mechanisms of its monetary policy.

only if aggregate domestic demand is the major determinant of inflation.¹² However, as already shown, under balance of payments dominance, exchange rate variations can have procyclical effects on aggregate demand. Furthermore, the supply shocks (positive or negative) that exchange rates have on domestic prices run in the opposite direction to those assumed by the inflation targeting regime, and may lead to procyclical policy decisions. Thus, if appreciation reduces the price level during booms, interest rates may not be adjusted in the required magnitude to cool domestic demand; in contrast, the inflationary effect of depreciation may lead to a suboptimal increase in domestic interest rates during crises to cool domestic price inflation. It is not surprising that the theoretical analysis of inflation targeting in open economies has indicated that a strict inflation targeting regime tends to increase real economic volatility (Svensson, 2000).

A “flexible” inflation targeting regime, which takes into account also real volatility, can correct in part these problems. However, the foundations of inflation targeting tend to weaken considerably under balance of payments dominance due to the fact that aggregate demand and the domestic price level have strong external determinants. As traditional structuralist price analysis indicates, this may be complicated by indexation mechanisms. Inflation targeting also assumes that demand is sensitive to interest rates, and that the interest rate set by central bank affect the overall structure of interest rates in the economy; both assumptions may be inappropriate in many (if not most) developing countries, due to inadequately developed domestic financial systems.

¹² This reflects the case which the orthodox literature has called the “divine coincidence” that by meeting the inflation targets authorities are able to keep economies at full employment. However, such outstanding result has been absent even in industrial economies, particularly during the recent global financial crisis. See Blanchard (2012).

For all these reasons, inflation targeting should be replaced by rules that accept that central banks must have multiple objectives. In developing countries, such objectives should be at least three: inflation, economic activity (employment) and the exchange rate.¹³ Today there is also broad agreement that financial stability should be added as a major objective, as independently of whether central banks are the regulatory authority, financial stability has clear macroeconomic dimensions. This does not mean that inflation should be a secondary objective, subordinated or contingent to achieving other objectives; in economies, such as those of Latin America, which have been prone to inflation, it should be a major one.

Obviously, an alternative reading of the “trilemma” is that what has to be given up is capital account liberalization. Furthermore, the multiplicity of objectives that monetary authorities should have implies that central banks should actively search for *more instruments*.¹⁴ This is reinforced by the fact that the effectiveness of each individual instrument may be limited, a fact that implies that the number of instruments should generally exceed the number of objectives. This is, in a sense, the essential lesson of macroeconomic management in open economies: the cost of rejecting the use of some instruments is high in economies subject to balance of payments dominance. The trade and capital account liberalization process led countries to give up many instruments used in the past to manage external shocks without creating new ones. Furthermore, given the fact that interest rate shocks faced by these economies are procyclical, attempting to

¹³ It is interesting to recall that in the US Federal Reserve System, the exchange rate is not an objective, but monetary authorities have three objectives: “maximum” employment, inflation and moderate long-term interest rates.

¹⁴ This is a central message of one of Stiglitz’s well known essays (Stiglitz, 1998).

counteract such pressures implies that an excessive burden was placed on the exchange rate, which does not always play a countercyclical role.

In the face of these dilemmas, many authorities in emerging and developing countries have pragmatically come to the conclusion, not only that polar exchange rate regimes are inappropriate but that they must use a broader set of instruments to manage the challenges typical of balance of payments dominance. The two favorite instruments have been a more active use of countercyclical variations in foreign exchange reserves, appropriately sterilized, and a return to some form of capital account regulations. Both can be clearly used in a countercyclical way and explain why the emerging economies tend to favor “intermediate” foreign exchange rate regimes, particularly *administered* exchange rate flexibility—and in several countries, highly administered flexibility. On top of this, a new layer of countercyclical instruments to manage prudential regulation have been added. These instruments, together with those associated with the administration of the capital account have come to be covered under the “macroprudential perspective”. Interestingly, some analysts include also under this concept some traditional instruments of monetary management that were widely used in the past—particularly reserve requirements on bank deposits—and that several countries had started to use again even before the crisis.¹⁵

The essential advantage of active foreign exchange reserve management is that it allows, within certain limits, to simultaneously control interest and exchange rates (see, in this regard, Frenkel, 2007). During booms, this requires sterilized accumulation of

¹⁵ See in this regard IMF (2010, ch. 3). However, it is useful to differentiate clearly between instruments of monetary and prudential regulation.

foreign exchange reserves, which then operates as “self-insurance”, enhancing the policy space for a macroeconomic management during the succeeding crisis. Foreign exchange reserve management also helps smooth out the effects of capital flows on exchange rates and thus the unstable incentives that it generates on the production of tradables. Obviously, sterilized interventions can be costly: at the national level, they generate losses if the return on the investment of reserves is lower than the costs of capital inflows (which it generally is); for central banks, there may also be losses if the instruments of sterilization are costlier than returns on reserves, including capital gains and losses made on foreign exchange management through the business cycle (this is a less important problem in economies with low domestic interest rates).

These costs imply that there may be significant benefits in avoiding excess capital inflows in the first place. The term “control” is generally used to refer to interventions in the capital account, rather than the most appropriate concept of “regulation”. Indeed, regulations on capital flows are of a similar nature to other types of regulations: they may be quantitative in character (e.g., prohibitions) or price-based (e.g., reserve requirements on capital inflows). Furthermore, those focused on avoiding excess capital inflows are clearly *prudential* in character, as they aim at correcting the risks associated with such excess inflows.

Capital account regulations operate in two distinct ways: they improve the liability structure of countries, making them less vulnerable to the greater volatility that characterizes certain flows, and they provide larger space for countercyclical monetary policy. In the latter sense, they enhance macroeconomic policy autonomy. In any case, the literature on this issue indicates that the effects of capital account regulations may be

limited and temporary.¹⁶ This does not mean that they should not be used. Rather, it means that they should be used in the magnitude necessary to be effective, and dynamically adjusted to compensate for the tendency of financial markets to elude them. In any case, since mechanisms used to evade regulations are costly, they show that regulations are at least partly effective. Among new instruments that can be designed, an attractive one is a reserve requirement on foreign exchange *liabilities* of both financial and non-financial agents, which may substitute the traditional reserve requirement on capital *inflows*. This would also make this instrument more similar to traditional instruments of monetary and prudential regulation, which operate on stocks rather than flows.

The use of capital account regulations with a countercyclical focus can be complemented with domestic prudential regulations, as was suggested by the Bank of International Settlements and ECLAC over a decade ago and was practiced by Spain since 2000.¹⁷ The recent global financial crisis finally inclined authorities to lean towards these instruments. The modality adopted by the Basel Committee in 2010 uses capital as the main countercyclical instrument, but it can be complemented with the countercyclical use of loan loss provisions (the Spanish system) and liquidity requirements, as well as those aimed at moderating the procyclical effects of asset price fluctuations, among others. In emerging and developing countries, an essential ingredient of those regulations must be the management of currency mismatches in portfolios, which tend to generate substantial risks and are one the basic reasons for the procyclical effects that exchange

¹⁶ See, for example, Ocampo (2008) and Ostry *et al.* (2010).

¹⁷ See the review of the debate on this issue in Griffith-Jones and Ocampo (2010) and of the Spanish experience in Saurina (2009).

rate fluctuations may have. Tax provisions can also be used for this purpose, particularly by changing the tax treatment of the external debt service, as suggested by Stiglitz and Battarcharya (2000).

The recent empirical literature comes overwhelmingly in favor of the view that the reduced *external* vulnerability was the major reason for the fair performance of developing countries during the recent global financial crises. Depending on the study, the reduced external vulnerability is associated empirically with a mix of five different factors: (i) lower current account deficits; (ii) competitive exchange rates; (iii) high level of foreign exchange reserves; (iv) reduced short-term external liabilities: and (v) capital account regulations in place.¹⁸ This confirms the view that balance of payments dominance is a major issue that developing countries must learn to manage to improve short-term macroeconomic performance. Other factors, such as strong fiscal accounts (where there are major exceptions, including India) and autonomous central banks following inflation targeting rules are less important. Some level of exchange rate flexibility is part of the story, particularly in medium and large-sized developing countries, but as extensively argued above, an administered regime in which flexibility is mixed with active countercyclical management of foreign exchange reserves is a better alternative.¹⁹

¹⁸ See, among many others, Frankel and Saravelos (2010), Frenkel (2010), Llaudes *et al.* (2010) and Ostry *et al.* (2010).

¹⁹ The classic treatment of intermediate regimes continues to be Williamson (2000).

Conclusions

This paper defines “balance of payments dominance” as a macroeconomic regime in which the short-term macroeconomic dynamics is essentially determined by external shocks, positive or negative. It argues that this is the predominant regime in emerging and developing countries. Trade shocks play an important role but the major procyclical shocks are associated with boom-bust cycles in external financing. Policy challenges are associated not only with the management of such shocks but also with the need to enhance the space for countercyclical macroeconomic policies, as boom-bust cycles tend to pressure macroeconomic policies to behave in a procyclical way. Countercyclical fiscal policies can play a role but face strong economic and political economy constraints, which explain why fiscal policies tend to be generally procyclical. The best bet is to design policies to reduce *external* vulnerabilities through a mix of administered exchange rate flexibility, very active foreign exchange reserve management, reduced reliance on external borrowing, and macroprudential regulations, including those directly affecting capital flows.

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