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Macroeconomic Balances in Emerging Economies: The Conflict Between Purely-Financial and Real-Economy Macrobalances

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INTRODUCTION

The macroeconomic environment of Latin American Countries (LACs) has been dominated by strong economic cycles in the last 30 years. East Asia entered in the same environment in the 1990s.

An increase in economic activity in the 1970s in LACs, ended with recession in the early 1980s and then opened a whole decade lost for growth. Subsequently, a recovery took place in the period 1990-94, which was followed by a recession, though a short one, in 1995. The biennium 1996-97 exhibited a strong recovery, with a sudden stop in 1998. In late 1999 a short-lasting recovery survived until early 2000. Finally, a recessive environment predominated until today; by now it is a sexennium (1998-2003) lost for economic growth and social progress, under the framework of the so-called Washington Consensus.

In financial crises in the 1960s and 1970s, imbalances of the fiscal sector tended to have an active, leading, role. That changed dramatically in the 1990s. If we disaggregate changes in aggregate demand into public and private components it is found that, rather than the public profligacy of previous decades, in the 1990s, in general, it was the private sector that led to booms and to busts. Large external deficits during the booms and moves towards surpluses in the busts were determined, mostly, by swings in capital flows.

Notwithstanding the diversity within LACs, these financial trends have dominated the evolution of actual GDP of the region as a whole. It is remarkable that the notably well behaved East-Asian economies have converged toward a rather similar behavior in the 1990s. Up to 1996, the successful emerging economies of Asia appeared to be immune to the instability associated with capital surges, as illustrated by their performance during the Tequila crisis. Actually, part of the outflows from LACs were reallocated to Asia (and South Africa) during that episode. The subsequent events have

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shown that immunity was no longer a feature of the East Asian economies, which implied that the two regions now faced common destabilizing external forces. The linking factor was that, during the early 1990s, several East-Asian economies started opening, their rather closed capital accounts, to liquid and short-term financial flows.¹ They did it in parallel with the surges in the supply of capital to EEs. As a consequence, these economies experienced similar movements toward several *vulnerability zones* (see chapter I.3).

In section 1 we stress the difference between “old” and “new” varieties of financial crises in emerging economies (EEs). In section 2 we examine main features of the three (and a half) financial capital surges in the last century. In section 3 we examine how capital surges have led to destabilizing cycles in the macroeconomic environment of most EEs. In section 4 we present an account of the economic and social costs of the Tequila and Asian crises in selected countries. Section 5 concludes.

1. A new variety of crises

Over the past third of a century, a “new” variety of crises has gradually developed in Asia and Latin America, with four features that differentiate them from the “old” type (Ffrench-Davis and Ocampo, 2001). First, the international capital market has been the major source of shocks to EEs, whether positive or negative. Second, flows have largely originated from private suppliers and has been received by the domestic private sector, i.e., they have been of the “private-private” type. Fiscal deficits have, on the contrary, played a secondary role and, indeed, in most experiences public finances have been rather balanced as compared to developed economies. Third, these financial crises have been suffered by EEs that usually were considered to be highly “credible and successful”. In fact, the bulk of private flows (large inflows followed by large outflows) has been concentrated in a small number of better-off and more organized developing nations.

¹ It is illustrative of the forces behind that move, that East Asia had large saving and investment ratios. Actually, the opening of the capital account was not commanded by the need to supplement low domestic savings (see Stiglitz, 2000, p. 1077).

Fourth, these flows have been characterized by a lack of regulation, or a pro-cyclical regulation, on both the supply and demand sides. Domestic financial systems have often been liberalized without the parallel development of a significant degree of domestic prudential regulation and supervision.²

Some very clear signals of imbalances in the old variety –lost of international reserves, rising CPI and fiscal deterioration– were substituted in the new variety by accumulation of reserves, falling inflation and improved fiscal balances. Evidently, the same policy recipe is not suited for two diametrically different conjunctures.

One, very revealing, additional difference is that the new variety of crises has been systematically synchronized. All the LACs tended to go into recession in the early 1980s; several did recess in 1995, and most EEs since 1998. The phenomenon has been so strong that has imprinted the overall evolution of GDP and aggregate demand of both regions as a whole. These crises have been preceded by booms in economic activity, in clear marked cycles, as discussed in section 2.

In practice, the differentiation between “old” and “new” crises is naturally somewhat less clear-cut than the above description would suggest. An early example of the “new” variety was the Chilean experience of the 1970s and early 1980s (Ffrench-Davis, 2002, chaps. 5 and 6), but the “old” type of crises was still prevalent in the rest of Latin America during that period, with other Southern Cone countries in an intermediate position. In the 1990s, the “new” kind generally predominated in Latin America but there were some mixed episodes in which new and old crises features were intermingled, with budget deficits and/or terms of trade fluctuations. Some old type cases were observed, too, like in Venezuela in recent years.

2. Three (and a half?) financial capital surges to Emerging Economies since the 1970s

Purely financial factors have been changing in the world at a much faster pace than international trade and the globalization of production and capital formation. Actually, only about one-fifth of world output crosses national boundaries; only about

² Interesting proposals for counter-cyclical devices are presented in Griffith-Jones and Persaud (2004); Ocampo (2003); Turner (2000); Williamson (2003a).

one-tenth of world investment is executed by FDI. Financial flows are over one hundred times the latter; the same funds can move several times during the day. Generally, the international financial booms have occurred in a framework of lax or non-existent regulations and supervision, and in which existing regulations were in fact procyclical.

Net capital inflows to Latin America averaged, in the three surges, nearly 5% of GDP (in 1977-81, 1991-94, and 1996-97). During all three periods, exchange-rates appreciated, which naturally led to a rapid increase of imports relative to exports, with the corresponding current-account deficit being financed (indeed, over-financed) by a sharp rise in the stock of external liabilities (ECLAC, 1998 and 2002a, IMF, 1998). Actually, all these macroeconomic variables experienced some overshooting. In many cases, “adjustment” was anchored to one dominant “balance”, which was generally associated with imbalances in other macro variables: frequently, a falling inflation rate at the expense of real exchange-rate appreciation and climbing external deficits. Such “adjustment” was obviously dependent from voluminous access to external financing; most probably, that destabilizing adjustment would not have been possible under a dry foreign supply.

The increased supply of external funding generated in those three episodes, in a process, a greater demand for such financing, associated with procyclical or passive domestic policies. For instance, while in 1991 the actual stock of assets invested in Latin America by the new investors that had *discovered* the emerging markets was evidently below their *desired* stock level, by 1994 it had become considerably larger. Net capital inflows, actually in a process instead of a one-shot, pressed for exchange rate appreciation; generally, it was a stepwise or gradual real appreciation, which naturally generated expectations of further appreciation; expectations of appreciation stimulated further inflows that pressed for additional appreciation. Thus, appreciation encouraged the use of inflows to finance rising current account deficits, for several years; consequently, external liabilities accumulated through time. This was, frequently, accompanied by significant mismatches in the maturity structure of the balance sheets of domestic financial intermediaries; particularly, when short-term external funds were used to finance longer-term domestic credits. This issue was severe for the dollarized segment

of the domestic financial system or in those cases in which external inter-bank credit lines were used as a major source of domestic financing.

Recipient countries that adopted such procyclical policies and thus experienced real exchange revaluation and larger deficits on current account, which were heavily financed by volatile –often short-term and liquid– capital flows, tended to become increasingly vulnerable to changes of mood by external creditors. The sensitiveness rises steeply with the size of liquid and net short-term liabilities (Rodrik and Velasco, 2000).

The dramatic increase of international financial flows in the 1990s was notoriously more diversified than in the 1970s. But the situation was potentially more unstable, inasmuch as the trend has been a shift from medium and long-term bank credit⁴, which was the predominant source of financing in the 1970s, to portfolio flow short-term bank financing; time deposits; non-greenfield FDI (acquisitions). As a consequence, a very high share of the newer supply of financing has been of a short-term and/or liquid nature, more volatile than long-term bank loans, and volatility has tended to be synchronized, in common processes of over-optimism and over-pessimism. Thus, paradoxically, there tended to be a *diversification toward larger volatility* in the 1990s; the relative improvement after the Tequila crisis, with a rising share of FDI,⁵ still included a significant proportion of volatile flows. This larger volatility was of the damaging sort, because generated wrong (but mistakenly credible) macro-prices and induced an irreversible misallocation of resources for several years.

In fact, the region moved into *vulnerability zones*, with the economy becoming increasingly sensitive to adverse political or economic news, and “hostage to the whims and fancies of a few country analysts in London, Frankfurt and New York” (Rodrik, 1998); a situation likely to “put the economy at the mercy of the capital markets occasionally whimsical moods” (Calvo, 1998a). The longer and deeper the economy’s incursion into a vulnerability zone, the more severe the *financieristic trap* in which

⁴ Typical maturity terms were 7-10 years.

⁵ The well documented positive link between FDI and productive investment (Ffrench-Davis and Reisen, 1998, ch. I), was weakened by the fact that about one-half of FDI inflows in 1995-2001 corresponded to acquisitions of Latin American firms instead of creation of new capacity. Acquisitions tend to be correlated to private financial outflows or with current fiscal expenditure, depending on who the seller is.

⁶ By “financieristic” we mean a macroeconomic policy approach that leads to an extreme predominance of or dependency from agents specialized in microfinance, placed in the short-term or liquid segments of the capital markets.

authorities could get caught, and the lower the probability of leaving risky zones without undergoing a crisis and long-lasting economic and social costs (Ffrench-Davis, 2003).

Mexico (Ros, 2001) and Argentina (Frenkel, 2004) were particularly entrapped in 1994, while Chile had deliberately avoided venturing into the *vulnerability zones* (Agosin and Ffrench-Davis, 2001). Meanwhile, East and South East Asian countries were just starting to take that risk during the first half of the 1990s. Notwithstanding their much strong position, with low external debt, large export drives and high savings, investment and GDP growth, they moved into *vulnerability zones*. They started to exhibit rising mismatches in the maturity structure of the balance sheets of domestic financial intermediaries, a worsening net debt position and maturity structure of firms, and climbing external deficits. By the next cycle inflexion, when adverse news emerged in East Asia during 1997, several economies, in both Asia and Latin America, had penetrated deep into *vulnerability zones*. This was reflected in severe crises in both regions when the mood of the external financial markets changed in that year.

3. Worsening of macroeconomic fundamentals led by inflows

The economic activity of LACs has exhibited significant vulnerability to changes in international financial markets in the last three decades, which have worked as an intense pro-cyclical factor. This vulnerability has been associated with the volatility of international markets, and with the procyclical macroeconomic policies adopted by recipient countries. As shown in Part I (ch. 3), sharp generalized swings in aggregate demand have been led by swings in capital flows. These features have reflected in volatile GDP growth and a low, disappointing, average. Pro-cyclical macroeconomic policies have been one determinant variable of that poor performance (Williamson, 2003b).

a) Volatile and poor growth

Annual GDP growth rose in LACs from 1.3% in the 1980s, to 4.1% between 1991 and 1994 and to 4.5% in 1996-97, but recessive adjustments took place in 1995 and in 1998-99 (see table 1). Overall, GDP rose by a mere 2.3% over the last fourteen years

(1990-2003). Since in 2003, in general, LACs were operating under a binding external restriction and domestic uncertainty (see next section b), they were placed below their potential GDP (GDP*). Actually, GDP* has probably averaged a growth rate in the order of 2.5–3%, with population rising 1.6%.

In any case, a growth of productive capacity around 1% per capita is remarkably low compared with the expectations generated by the structural reforms made under the umbrella of the so-called Washington Consensus. Comparison with the previous golden age is striking. During the three decades from 1950 to 1980, GDP growth averaged 5.5% per annum (2.7% per capita); with rather high domestic investment ratios sustaining these vigorous rates. It was a long period of development convergence of Latin America with the United States. In the 1980s, gross domestic investment dropped sharply, by 7 percentage points of GDP. A recovery of capital formation in the 1990s was, in contrast, weak (see figure 1). It is revealing that investment grew much less during this decade than capital inflows did; actually, a significant proportion of external flows financed increased consumption, thus crowding-out domestic savings (see Ffrench-Davis, 2000, chs. 1 and 5; Uthoff and Titelman, 1998).

[Table 1 and Figure 1]

These GDP cycles have all been led by changes in the domestic macroeconomic environment in response to changes in capital flows. In fact, figure 2 records that, actually for LACs, changes in economic activity since the 1970s have been notably intense, covering several strong cycles. These cycles were all led by changes in aggregate demand. In a dynamic chain, these were led by changes in net financial transfers from abroad (figure 3)⁷. During the booms, the increase in aggregate demand (associated to shocks in capital flows rather than on trade), has tended to be followed by an increase in actual output of non-exports, a faster increase in imports than in exports and a worsening of external balances; vice-versa in the busts, with improvements in external balances but depressed rates of use of non-exports GDP*.

Figure 4 shows that a given change in aggregate demand generated about 2/3 of changes in actual GDP and 1/3 in the external balance. Effects on actual GDP appear to

⁷ In chapter I.3 it was run a Granger causality test between capital inflows and GDP growth in Latin America, finding that the first causes the latter. Given the strong positive correlation between both variables, we can conclude that business cycles have been led by capital flows in Latin America.

be *symmetrical* in the upswings and downswings, which reveals that the region has been generally operating under the production frontier (below potential GDP)⁸. If the economy were placed at the frontier, an increase in demand could not lead to an increased GDP, and would tend to reflect totally in an external deficit and/or inflation.

In a well-behaved EE, with GDP* growing *pari passu* with the aggregate demand in a real macroeconomic balance, what we would observe, in parallel with growth, a falling external deficit, with an equilibrating exchange rate appreciation and/or a transit along the debt life cycle (Devlin, Ffrench-Davis and Griffith-Jones, 1995; Ffrench-Davis, 2000, ch.5). The coefficient in the equation inserted in figure 4 would tend to be less than 1.

[Figures 2, 3 and 4]

b) *Initial benefits from capital inflows in economies in recession*

The domestic conjuncture has crucial implications for the link between capital flows and economic activity. When there is a binding external constraint (BEC), any inflow will tend to contribute to relax it, as well as to overcome over-pessimism of domestic agents, thus facilitating a recovery of economic activity. BEC has been predominant during several episodes in many LACs, and was particularly widespread from the early 1980s up to 1990, in 1995 and in 1998-2003.

During the early 1990s, renewed capital inflows actually contributed to a recovery of economic activity. Moreover, they facilitated the adoption of successful anti-inflationary adjustment. Argentina and Peru are two outstanding cases of countries which, before the capital surge, featured huge underutilization of capacity and hyperinflation; the disappearance of the BEC and reintroduction of macroeconomic discipline to combat hyperinflation were strongly complementary. Given a significant output gap, the monetary effects of reserve accumulation and the wealth effects of exchange-rate appreciation pushed-up aggregate demand, facilitating the recovery of economic activity. At the other end of the spectrum, in Chile and Mexico capacity

⁸ This *symmetry* tends to lead to the wrong conclusion that capital flows are the leading variable for sustained growth. The fact is that the opposite happens: the mentioned pro-cyclical behavior of flows keeps the economy, in average through time, significantly below the production frontiers (a large output gap).

underutilization was not significant and thus the automatism of the capital flow-actual GDP growth (recovery) link was absent. A positive link was then contingent upon the capacity to transform additional external financing into increased productive investment; that did happen in Chile (with a real macro of three pillars, while Mexico failed in that challenge (with a macro of only two pillars).

On average, in 1991-94, thanks to increased capacity utilization, Latin American GDP rose faster than the expansion of the production frontier. It is estimated that about one-third of the 4.1% annual GDP growth in 1991-94 was based on increased capacity utilization. In 1995, a BEC became a crucial variable once more, with GDP growth (1.0%) lagging behind capacity growth. Renewed capital inflows in the following years again contributed to a recovery of economic activity in 1996-97, based to some extent on the excess capacity generated in 1995. But the return of a BEC in 1998-2003, particularly in South America, led to a new recession with an annual growth of actual GDP of 1.2%, while potential GDP may have been rising at about twice that speed. As a consequence, the output gap expanded in this six-year period and depressed the investment ratio. One interesting analytical point is that downward adjustment tends to be abrupt and recovery tends to be gradual (ch.I.3, and Calvo 1998b; Ocampo, 2003; Rodrik, 2001).

One implication of this analysis is that any serious research should control for the huge swings in the rate of capacity utilization when measuring productivity and the performance of policies and reforms, as discussed in chapter I.3.

c) *Overshooting in emerging economies*

The increased availability of financing in the 1990s removed the BEC that had been responsible for the Latin American decade-long recession. However, the bases for growth were not laid down, as neither investment nor productivity did increase rapidly, while other imbalances were built up. Thence, actual output gradually approached the production frontier, while external liabilities accumulated (figure 6) exchange-rate appreciation led at some point to overvaluation⁹, and asset markets overshot (figure 7).

⁹ It should be recalled that several LACs were implementing sharp liberalization of import regimes *pari passu* with exchange-rate appreciation. See Ffrench-Davis (2000, ch. 3) and ECLAC (1998, ch. V). The average import tariff was cut-down from 45% in the mid-1980s to 13% in the mid-1990s; in addition, non-tariff restrictions were reduced sharply. Usually, this implies a depreciation of whichever was the

Together with the accumulation of external liabilities, that were largely liquid, this made the economies more vulnerable to future negative external shocks. With some variations, this story applies to both 1991-94 and 1995-97, reproducing the path towards the crisis of 1976-81.

[Figures 6 and 7]

During 1995, the Tequila crisis had negligible effects on the Asian region, even in economies with large current account deficits, such as Malaysia and Thailand. Consequently, 1996 saw many outstanding researchers and observers asserting that such deficits were not relevant if investment ratios and economic growth were high.

Several Asian countries had regulated capital inflows and foreign exchange markets successfully for long periods¹⁰. Economic growth was actually sustained and extremely high. From 1970 to 1996 (over a quarter of a century), average yearly GDP growth in East Asia exceeded 7% (see table 1, above); the investment ratio frequently moved around one-third of GDP, with domestic savings ratios at a similar level; inflation was low (in the annual range of 5%) and fiscal budgets were generally balanced or in surplus (with the exception of Taiwan). Meanwhile, average GDP growth in Latin America was 2 or 3% and the investment ratio fluctuated around 20%.

What is the explanation for the sudden worsening in Asia? Was it a sudden jump in crony capitalism? Or, principally, it responded to other variables, somewhat shared with Latin America, that reflect a severe shortcoming of a macroeconomics of two pillars (low inflation and fiscal discipline) with a missing or worsening third pillar (that of adequate aggregate demand and *right* macro-prices)? Data consistently signals that the real macroeconomic environment for producers, including balance sheets, was unbalancing in East Asia since early 1990s, associated to the capital account opening.

First, the strong drive towards financial liberalization prevailing in the world had also permeated several Asian economies in the 1990s (Agosin, 2001; Akyüz, 1998; Furman and Stiglitz, 1998; Jomo, 1998; Krugman, 1999; Stiglitz, 2002). China, India and Taiwan were three notable exceptions. Actually, capital inflows and deficits on current

‘equilibrium exchange rate’.

¹⁰ See the cases of Malaysia, Indonesia and Thailand, in Sachs, Tornell and Velasco (1996); Korea and Taiwan, in Agosin (2001); Korea and Malaysia, in Mahani, et al.(2004); Malaysia, in Kaplan and Rodrik (2001) and Khor (2004).

account increased substantially in most East Asia from 1992 on. External imbalances were not associated with public deficits and did not imply losses of international reserves: in fact, in Korea, Indonesia, Malaysia and Thailand, international reserves, fed by capital inflows, accumulated consistently between 1992 and early 1997, over doubling in that period. All the data points to the cause of disequilibria being a private expenditure rise led by capital inflows, which permitted liquidity constraints to be relaxed (Marfán, 2004). The induced domestic lending boom was also accompanied by bubbles in real estate and stock market prices. In some cases, cheaper imports, due to real exchange-rate appreciation and some import liberalization, also fed the import boom.

Second, most inflows were short term or liquid, including a large proportion of inter-bank lending (IMF, 1998; Radelet and Sachs, 1998). Domestic balance sheets thus became quite vulnerable as a result of maturity and currency mismatches and the rapid rise of firms' leverage (Krugman, 1999). Weak prudential supervision of the financial system, not such a threat in previously repressed domestic markets, became evident with financial liberalization and the lending boom.

All these penetrations in *vulnerability zones* were complemented with a negative external trade shock in the mid-1990s. Then, export performance in several Asian economies weakened. Export sectors that had been experiencing notably dynamic demand suddenly faced tightening markets, either as a result of temporary excess supply (Radelet and Sachs, 1998) or because some markets were reaching maturity. The long Japanese crisis and devaluation in China did contribute to the intensity of these problems.

In these Asian economies vulnerability was thus associated with worsening macroeconomic fundamentals led by a capital surge, which carried over to an exchange-rate appreciation (moderate as compared to that in Latin America), a boom in aggregate private demand (with a significant enlargement of the current account deficit by 5 percentage points of GDP in Korea, and 3 points in Thailand) and to the increased vulnerability of the balance sheets of domestic financial intermediaries. The disequilibrium was recognized by financial markets only in 1997 and resulted in a weighty bill in 1998. The policy failure was an error shared with the rather similar financial reforms conducted in the Southern Cone, particularly in Chile, in the 1970s

(Ffrench-Davis and Tapia, 2001) and across Latin America, illustrated by Argentina (Frenkel, 2004) and Mexico in the 1990s (Ros, 2001).

The recessions in East Asia in 1997-98 were comparable to those of Latin America in 1982-83, with drops in productive investment, banking crises and social regression. Apart from the intrinsic strengths of the economic structure of several Asian economies, four features of the international economic environment explain to a large extent why the shift from recession to recovery came sooner than during the Latin American debt crisis: the plentiful supply of official external financing; rapid action spearheaded by the United States authorities to refinance private credits, particularly inter-bank lending; significantly lower interest rates in the advanced economies and higher growth rates, particularly the United States. Another salient feature is that the countercyclical monetary and fiscal policies implemented by Korea and Malaysia. For instance, in Korea the public sector played a significant role in the recovery; consequently, the fiscal balance swung from a surplus of 0.4% of GDP over the period 1993-96 to a deficit averaging 3.5% in 1998-99.

d) *Why the market overshoots*

On the whole, in both Latin America and East Asia, the authorities took a procyclical approach, allowing capital surges to be transmitted domestically. In consequence, as discussed in ch.I.3, they fell into a *financieristic trap*, from which it becomes highly unlikely to escape without a traumatic adjustment, involving outlier exchange or interest rates, and considerable liquidity constraints which, together, generate a very unfriendly macroeconomic environment for firms and labor.

Most authorities (as well as observers) took the view that there was nothing that could or should be done during the expansive stages, or preferred to “benefit a little longer” from the capital boom. Only ex-post, the consensus of observers was that disequilibria had accumulated. Given that voluntary flows cannot take place without the willing consent of both debtors and creditors, why did neither agent act in due time to curb flows? Why, when some specialists have been able to notice and warn of the

growing vulnerability in the three episodes examined, did the market fail to avoid major crises? ¹¹

The particular nature of the agents acting on the creditor side is crucially important.¹² Agents dealing with short-term horizons are a significant part of the story of the 1990s. For the most influential financial operators, the more relevant variables are not related to the long-term fundamentals but to short-term profitability. This explains why they may suddenly display a radical change of opinion about the economic situation of a country whose fundamentals, other than liquidity in foreign currency, remain rather unchanged during a shift from over-optimism to over-pessimism.

The gradual spread of information on investment opportunities is another key influence. Agents from different segments of the financial market became gradually drawn into the international markets as they took notice of the profitable opportunities offered by EEs. This explains why the three full surges of flows to emerging economies were *processes* that went on for several years rather than one-shot changes in supply. This is revealed, for instance, in the evolution of the stock and foreign exchange markets (see figure 7, above).

The interaction between the two sets of factors –the nature of agents and a process of adjustment– explains the dynamics of capital flows over time. As discussed in chapter I.3, after a significant increase in asset prices and exchange-rates, accompanied by rising stocks of external liabilities, the probability of reversal of expectations about their future trend grows steeply.

It is no coincidence that, in all three surges, loan spreads underwent a sustained fall while the stock of liabilities rose sharply: for 5-6 years in the 1970s; 3-4 years before the Tequila crisis, and over a couple of years after that crisis. This implies, during the expansive side of the cycle, a downward sloping medium-run supply, a highly destabilizing feature indeed. In this respect, it is interesting to observe the evident parallel between spreads of Mexico until 1999 (today still praised as a well-behaved reformer in the 1990s) and Argentina (qualified in financial markets and IFIs as a non-reformer in

¹¹ For instance, see a warning advice on Latin America, as early as in mid-1992, reproduced in Ffrench-Davis (2000, ch. 9).

¹² In Ffrench-Davis and Ocampo (2001) and Ffrench-Davis (2003) we discuss further this issue. See also ch.I.3.

the 1990s). Apparently, for many years, creditors and financial investors did not perceive any significant difference between the two countries (see figure 2, in Ffrench-Davis, 2003).

One particularly relevant issue is that economic agents specialized in microfinance, who may be highly efficient in their field but are short-sighted “by training and by reward”, have come to play a determining role in generating macroeconomic conditions and policy design. This leads, unsurprisingly, to unsustainable macroeconomic imbalances, and “wrong” or outlier macro-prices. Then, it is “irrational”, and evidently inefficient from the perspective of resource allocation, that the decisions of authorities, which should obviously be taken with a long-term view, become entrapped with the lobbying and policy recipes of microfinance experts and the financial press, what has frequently led (using Greenspan’s expression) to “irrational exuberance”. On the contrary, macroeconomic authorities need to avoid entering *vulnerability zones* during economic booms-cum-capital surges, since otherwise policy design is prone to be caught in the *financieristic trap*. In that case, it is lost the policy independence from financial markets, whose concerns are other than *real* macroeconomic balances. It becomes a contradiction with the essence of an ‘independent’ central bank.

4. Economic and social costs of the Tequila and Asian crises in three country cases

There is a common assertion in the economic literature that the only correct way to conduct policy is with an open capital account, as Korea and Mexico did in the 1990s. The strong fact is, however, that there is significant room for policy diversity. Actually, Chile is one of the cases that provides one striking example of policy diversity and successful prudential macroeconomic management of the capital account. Here we discuss briefly these three cases¹³.

a) Mexico and the Tequila crisis

The Mexican crisis which exploded in 1994 illustrates the harm that can be

¹³ The following analysis is based on Ffrench-Davis and Ocampo (2001). See also Agosin (2001); Ffrench-Davis (2000, ch.10; 2002, ch.10); Ros (2001).

caused by the absorption of an excessive volume of capital inflows, giving way to the accumulation of a large stock of external liabilities, --especially when the composition of such financing is short-term or liquid--, and to a domestic credit boom (Ros, 2001; Sachs, Tornell and Velasco, 1996). Between 1990 and 1994, producers and consumers accommodated to a level of overall expenditure that rapidly outstripped potential GDP: expenditure in aggregate demand plus capital services exceeded actual GDP by 8% in 1992-94. The real exchange-rate appreciated significantly, contributing to the sharp rise of the external deficit. Since the public sector had moved to a balance (or surplus) in 1992-94, the disequilibrium was located in the private sector.

The widespread belief that withholding of information prevented the Mexican crisis of 1994 being foreseen is mistaken. While the provision of official information on international reserves was admittedly only sporadic, the key data --real exchange-rate appreciation, the high current-account deficit and its financing with volatile resources, and low GDP growth despite booming flows-- were available on a regular basis. Also, there was data available recording a significant crowding-out of domestic savings. Notwithstanding this, by 1993 Mexican policies were widely praised by financial institutions, the media and risk rating agencies (Gurría, 1995, p. 281), while the incorporation of Mexico to two clubs of wealthy nations in 1994 --NAFTA and the OECD-- served to intensify the trend. The crucial problem was that neither those on the supply side nor those on the demand side paid sufficient attention to the available information until after the crisis erupted.

When expectations of profitability were reverted, *pari passu* the well-known events of 1994, creditors did cut financing sharply, forcing Mexico into a highly contractionary adjustment, and huge devaluations (principally after authorities adopted a flexible exchange-rate). Despite the large package of international support that Mexico received in 1995 (Lustig, 1997), a drop of 6.1% in GDP and of one-third in capital formation occurred in that year. Both were led by a dive of 14% in aggregate demand.

GDP recovered strongly shortly afterward, but the overall GDP rise averaged only 2.5% in 1995-2003, including good and bad years. Significantly, average GDP growth was slow despite the fact that Mexico benefited from a vigorous positive shock as a result of the United States boom, particularly of imports which was reflected in a

Mexican GDP growth of 7% in 2000 and a vigorous expansion of export volume by 10% per year in 1995-2003 (13% in 1995-2001), four-fifths of which were directed to the US markets. After a sharp drop in 1995, the investment ratio did not fully recover until 1999. Real wages decreased substantially during the crisis and had not recovered by 2003.

The Mexican crisis did not trigger a widespread contagion effect throughout the region in 1995, in contrast to 1982¹⁴. The most notable exceptions in the region were Argentina and Uruguay, which were seriously affected by contagion, with significant drops in GDP, employment and investment in 1995.

Nonetheless, during 1995 many countries experienced negative flows in several segments of the external supply of financing, particularly bonds, deposits and flows to stock markets; actually, in the first months of 1995¹⁵, almost all stock markets in LACs became severely depressed, prices (in US dollar equivalent) nearly halved (Chile excepted), and outflows predominated. Subsequently, the flow of funds became extremely abundant again. GDP recovery in Argentina, Mexico and Uruguay was particularly vigorous; given the sharp drop in these countries in 1995, there was a large output gap between actual GDP and productive capacity. This permitted a significant degree of reactivation, which led to a complacent view –in those countries, in International Financing Institutions (IFIs) and nearly everywhere– of the effects of crises and the capacity to recover from them (see Ffrench-Davis and Ocampo, 2001 on this issue).

Mexico moved in 1995 from an actually quasi-fixed nominal exchange-rate to a flexible rate, which facilitated the adjustment to the financial shocks generated by the Asian crisis. Meanwhile, Argentina, tied to the currency board, was experiencing negative shocks from Asia, from the devaluation of the Brazilian currency and the revaluation of the US dollar. As a consequence, the inability of Argentina to facilitate the correction of relative prices with the active use of the nominal exchange-rate, the adverse additional effect of the strong international appreciation of the US dollar, and the

¹⁴ The huge (higher than required) financial support to Mexico (mentioned above), a vigorous world trade in 1994-95 and improved terms of trade for LACs, contributed to that recovery.

¹⁵ Chile also experienced capital outflows from the stock market in 1995. However, since inflows had been moderate and the economy exhibited generalized real macroeconomic balances, those outflows generated no macro problem. Previous prudential macroeconomic regulations of Chile –included the so-called Chilean style reserve requirement– gave its generous fruits in 1995.

persistent dryness in the supply of external funding,¹⁶ explain its negative outcome.

b) Korea and the Asian crisis

The East Asian countries suffered deep recessions, mostly in 1998, after decades of sustained annual GDP growth of around 8%. Indonesia exhibited a 13% recession, similar to the spectacular drop of Chilean GDP in the recession of 1982. For Korea, Malaysia and Thailand reductions of 7 to 11% were recorded. The specific nature of the crises varied from one country to another within Asia. However, as in LACs, they appeared to be associated with the capital surge of the 1990s and the resulting excess liquidity. During 1999-2000, Korea recovered fast, (as well as Malaysia, the two best-behaved recoveries in EEs). Notwithstanding Korea's impressive GDP growth in 1999 and 2000, the costs have been significant. In the period 1998-2000, GDP was about 12% below where it would have been had the historical trend continued, and a drop of over one-fifth was recorded in investment in the biennium 1998-99 as compared with the quatriennium 1993-96 (29% and 36%, respectively). Since the country also achieved an impressive external surplus of 9% of GDP in that biennium, versus a deficit of 4-5% in 1996, disposable income was well below output.

Until the early 1990s, Korea had extensive capital account regulations, based on a combination of market forces and State guidance (Agosin, 2001; Furman and Stiglitz, 1998; Mahani et al, 2004). In 1991, the country began implementing a broad range of measures aimed at liberalizing the capital account. Contrary to common assumptions by observers, greenfield FDI –not acquisitions– was deregulated. Also, local firms and banks were allowed to issue securities abroad and foreigners were authorized to purchase stocks in Korean companies subject to limits that were raised progressively as of 1992. Foreign-currency loans to local firms, trade credit and short-term financing were also liberalized. Only long-term borrowing and acquisitions remained restricted. Under the new regulations, Korean banks and firms were permitted to engage in arbitrage between international lenders and local markets, by borrowing short abroad and in some cases lending long-term at home. This practice would not have been allowed under the

¹⁶ The international capital markets has undergone a lengthy dryness since the 1998 crisis, except during the boom in the US economy and the acceleration in Europe in late 1999 and early 2000.

regulations prevailing before the liberalization drive in the early 1990s. In addition, Korea's sound creditworthiness afforded local firms lower spreads and more expeditious access to funding, which they used partly to borrow for financing investment and lending in other Asian markets.¹⁷

Capital inflows expanded hugely after liberalization, including purchases of stock shares, bond issues and private loans to banks and non-financial firms; liabilities became highly liquid, with short-term debt doubling international reserves in 1996. This was not accompanied, however, by strengthened prudential regulation and supervision, in a replication of the negative Latin American experience (see ECLAC, 1998, ch. XII).

In the process of liberalizing the capital account, the exchange-rate appreciated (though moderately) with respect to the currencies in which borrowing took place, which encouraged further borrowing. Korea accommodated to the capital surplus through some import liberalization and currency appreciation, and relaxation of domestic liquidity constraints. The combined effect of increased imports and worsening export prices explain the rise in the current-account deficit to 5% of GDP in 1996. Net inflows rose from US\$7 billion in 1992 to US\$24 billion in 1996, but gross inflows amounted to US\$ 49 billion.

The opening of the capital account represented a source of vulnerability, exacerbated by a bank regulation and supervision not accommodated to the severe challenge posed by financial and capital account liberalization; it left Korea prone to contagion, even though the fundamentals were sound in general.

c) Chile: going against the fashion in the 1990s

Is it possible to forge ahead with policies that contrast with contemporary economic ideology? Chile in the first half of the 1990s provides evidence that it is indeed possible and can be an efficient and cheap way to insure against costly crises.

Chile deployed three types of capital account policy in the last quarter of a century (Ffrench-Davis and Tapia, 2001). The first was the plain neoliberal experiment of the 1970s, which culminated in a major crisis in 1982, with a drop of 14% in GDP, and

¹⁷ In May 1995, one of the large international risk-rating agencies had upgraded the sovereign credit rating of Korea (see Mahani, et al, 2003). Then, in June 1997, the World Economic Forum had classified Korea as the fifth most secure place to invest in the world.

then a rise in open unemployment to 30% in 1983. The second was the approach taken from 1990 to 1995, which -in contrast with the prevailing recipe in fashion- consisted of a set of active macroeconomic policies, that included the prudential regulation of financial inflows; as a result, Chile remained practically unaffected by the Tequila contagion. The third case took place after 1995, with a relative relaxation of macroeconomic prudential policies. This allowed significant appreciation, and accommodated the rise in the external deficit (which doubled, as a proportion of GDP, in 1996-97 compared to 1990-95: 4.5% and 2.3%, respectively).

Chile's performance was diametrically opposed to that of Mexico in 1995, despite numerous similarities displayed by the two economies during the preceding years. The difference in results is associated to the notorious divergence in macroeconomic policies in the first half of the 1990s.

Towards the end of the 1980s, both countries had already liberalized their trade considerably, they had substantially improved their fiscal budgets, privatization was well underway, the annual rate of inflation was around 20-30%, and they showed similar domestic savings ratios in the late 1980s. In 1990-94 Chile and Mexico chose divergent approaches with respect to the management of capital inflows, exchange-rate policy, and prudential regulation and supervision of the domestic financial system. The main reason for Chile's advantage over Mexico in 1995 is that it responded to the abundance of external funds since 1990 with a deliberate policy of active prudential macroeconomic regulation.

Instead of allowing-in and spending all the large external supply available, which would have led to significant appreciation of the peso and a rising deficit on current account, the Chilean authorities chose to discourage short-term capital inflows. In 1991 a tax was imposed, and significant non-interest-bearing reserves were required for external loans; the reserve requirement was subsequently extended to foreign-currency deposits and investment in second hand stocks, while primary issues of ADRs and FDI venture capital were kept exempted; investments had to be held in Chile for at least one year; the financial system was subject to relatively strict prudential regulation, including a selective supervision of bank assets and required provisioning, as well as restrictions and drastic penalties on operations with related parties. This set of measures effectively

discouraged speculative funds, thus reducing the net amount of capital inflows. Most empirical research shows that these regulations had a significant effect on the volume of short-term inflows, and several studies, contrary to a most common belief, also show an effect on total inflows (Agosin and Ffrench-Davis, 2001; Le Fort and Lehmann, 2003; Zahler, 1998).¹⁸

Together, the smooth transition to democracy in 1990, an increasing international approval of Chilean economic policies and high domestic interest rates, boosted capital inflows to Chile since mid-1990, *earlier* and relatively *stronger* than to other EEs. Notwithstanding this fact, as a consequence of its set of prudential macroeconomic policies, by late 1994, Chile had a moderate external deficit, high international reserves, a manageable short-term debt, a domestic savings rate that was rising instead of falling (the latter being the case in Mexico), and a level of domestic investment that from 1993 onward far exceeded historical records, the exchange-rate in 1990-94 was comparatively closer to equilibrium¹⁹ than that in most LACs, as reflected by the moderate deficit on current account over that period.

Policy was effective in achieving its targets for most of the 1990s. In 1996-97, however, this policy mix and the intensity with which it was applied remained unchanged, despite a new vigorous capital surge to most countries in the region, but particularly to Chile, which had remained immune to the Tequila contagion. This surge should have been met with increased restrictions on rising inflows but, in the absence of such a measure, inflows came in excess into the domestic economy paying the then insufficiently restrictive cost of the reserve requirement, with no evidence of significant evasion; as Le Fort and Lehmann (2003) emphasize, also some inflows, which ought to have been made subject to regulation, remained exempt.

As a consequence, despite heavy intervention in the foreign exchange market by the Central Bank, a sharp real exchange-rate appreciation and a rise of the deficit on current account were observed over the biennium, which pushed Chile into a *vulnerability zone*. Nonetheless, the active regulation implemented up to the mid-1990s

¹⁸ The classical paper arguing against the effectiveness of the Chilean reserve requirement is Valdés-Prieto and Soto (1998).

¹⁹ The Chilean RER had appreciated 4% in 1994 as compared to 1987-90 while in average Latin American countries had appreciated 24% (measured with comparable CEPAL figures).

had left large international reserves, low stock of foreign liabilities and a small share of volatile flows. Unfortunately, those strengths were partially undermined by the excessive exchange-rate appreciation, a rather high 4.5% deficit on current account recorded in 1996-97, and the Central Bank's delay in reacting to the deterioration of the external environment. In particular, the Bank resisted market pressures for devaluation, concerned that exchange-rate depreciation would result in higher inflation, and in worsened balance sheets of large domestic firms highly indebted in foreign currency liabilities during the biennium. The outcome was a sort of "automatic" adjustment, with a sharp loss of reserves, a 6% fall in aggregate demand and a 1% drop in GDP, a 3.5 percentage points rise in the unemployment rate, and a marked reduction in capital formation in 1999. Despite this recent recession, however, Chile achieved an average growth rate of 6.3% for the 1990s (including the recession of 1999), which was its best performance ever recorded in a decade.

5. Concluding remarks

It is crucial to ensure that the volume of inflows is consistent with the absorptive capacity of the host country. The failure to address this point is at the core of recent macroinstability in EEs. Absorption capacity must refer, of course, to both the use of existing productive capacity and to the creation of new one. The composition of flows is relevant on three dimensions. First, FDI (excluding acquisitions of existing assets) feeds directly into capital formation, as do long-term loans to importers of capital goods. Second, volatile flows tend to impact more directly on foreign exchange and stock markets; and are more weakly associated to capital formation, which requires long-term financing. Third, temporary capital surges tend to leak into consumption, due to the faster capacity of consumers to respond to financial swings, as compared to irreversible productive investment.

Allowing an excessively large share of capital inflows to drain off into the stock exchange and consumption of imported goods, will usually create bubbles in asset markets and imbalances in the external sector, which tend to be unsustainable. Particularly, fast rising stocks of net liquid foreign liabilities generate deep

vulnerabilities. Consequently, higher ratios of long-term flows and of productive investment imply a higher capacity for efficient absorption. Under these conditions, a higher volume of capital flows can be absorbed efficiently and may become sustainable.

Recent experience offers a dramatic demonstration that recipient emerging economies can pay a high cost for allowing the financial markets, dominated by agents with short horizons, to determine the volume and composition of capital flows. This is why the microeconomic costs associated with the use of regulations on capital inflows should therefore be balanced against the social benefits in terms of macroeconomic stability, investment and growth. Effective and efficient regulation can result in higher and sustained GDP growth, demonstrated, as we have shown, by Chile in the 1990s.

It is therefore unwise to make an inflexible commitment to fully opening the capital account, particularly in the light of the crucial importance of real macroeconomic stability, in combination with the disproportionate volume of the international capital markets as compared with the small size of EEs markets. As long as flows depend on short-term horizons and domestic securities markets remain shallow, this new modality of linkages with the global economy will carry the risk of severe instability, and strong deterrent to growth. The recent experiences of EEs rated as “successful” economies attest to the wisdom of discouraging the accumulation of large short-term financial liabilities. A set of domestic prudential macroeconomic regulations offer an effective insurance, particularly in order to managing booms. Since it is a market-based set of policies, including, for instance, the Chilean-style reserve requirement, its strength must be adjusted to the intensity of the supply of funds.

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Table 1
Latin America and East Asia: Gross Domestic Product, 1971-2003
(annual growth rates, %)

A. Latin America

	1971-80	1981-89	1990	1991-94	1995	1996-97	1998-2002 ^a	1990-2003 ^a
Latin America (19)	5.6	1.3	-0.6	4.1	1.0	4.4	1.2	2.3
Argentina	2.8	-0.7	-2.0	8.0	-2.9	6.7	-1.4	2.2
Brazil	8.6	2.3	-4.6	2.8	4.2	2.8	1.3	1.7
Chile	2.5	3.0	3.3	7.5	9.0	6.8	2.6	5.1
Colombia	5.4	3.7	3.2	3.9	4.9	2.6	0.6	2.3
Mexico	6.7	1.5	5.1	3.5	-6.1	6.1	2.9	3.0
Perú	3.9	-0.7	-5.4	4.9	8.6	4.7	2.0	3.1
Venezuela	1.8	-1.5	6.0	3.2	4.8	3.4	-2.8	0.9

Source: ECLAC, expressed in US dollars at 1980 prices for 1971-80, at 1990 prices for 1980-89, and at 1995 prices for 1989-2003. ^a Provisional figures.

B. East Asia

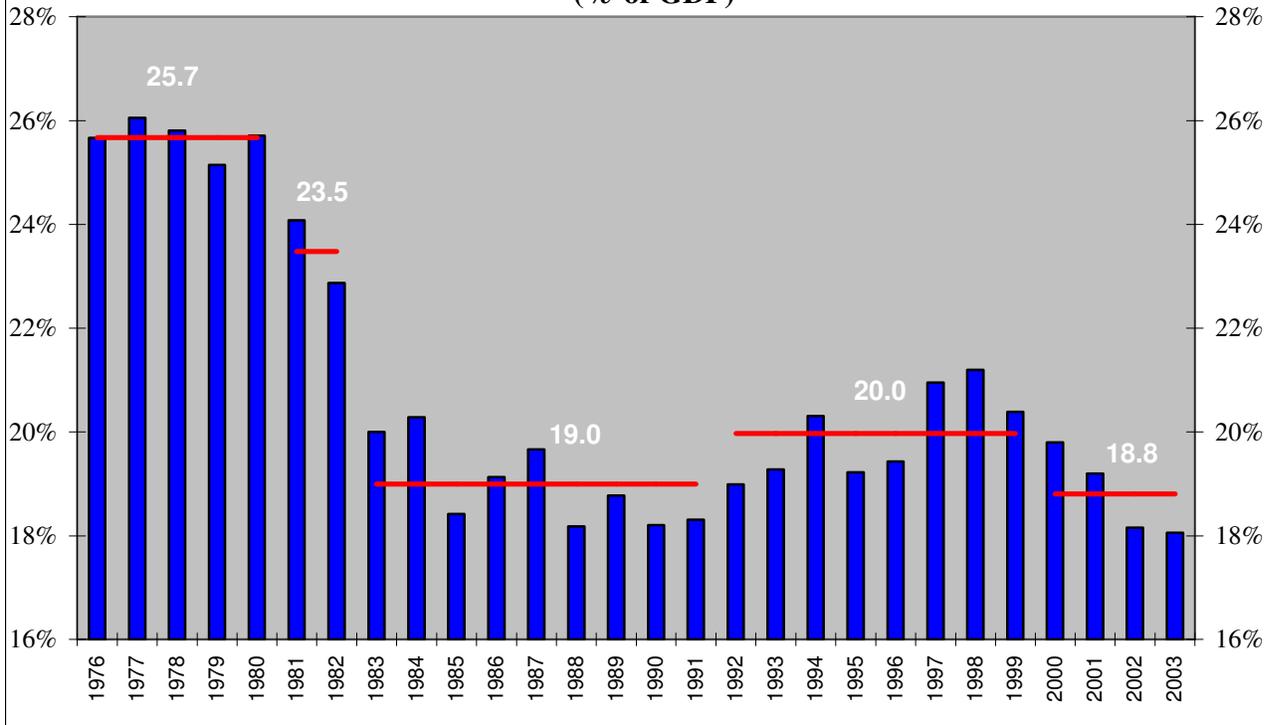
	1971-80	1981-90	1991-96	1997	1998	1999-2003	1990-2003 ^a
East Asia (6)^b	8.1	7.0	7.3	4.6	-5.4	4.6	5.2
Indonesia	7.7	5.5	7.8	4.7	-13.1	3.2	4.4
Korea	9.0	8.8	7.3	5.0	-6.7	6.5	5.9
Malaysia	7.8	5.2	9.6	7.3	-7.4	4.6	6.3
Philippines	5.9	1.7	2.8	5.2	-0.6	3.8	3.1
Taiwan	9.3	8.5	6.9	6.7	4.6	3.1	5.3
Thailand	7.9	7.9	8.2	-1.4	-10.6	4.4	4.9

Sources: IMF, *International Financial Statistics*, June 2002, Asian Development Bank.

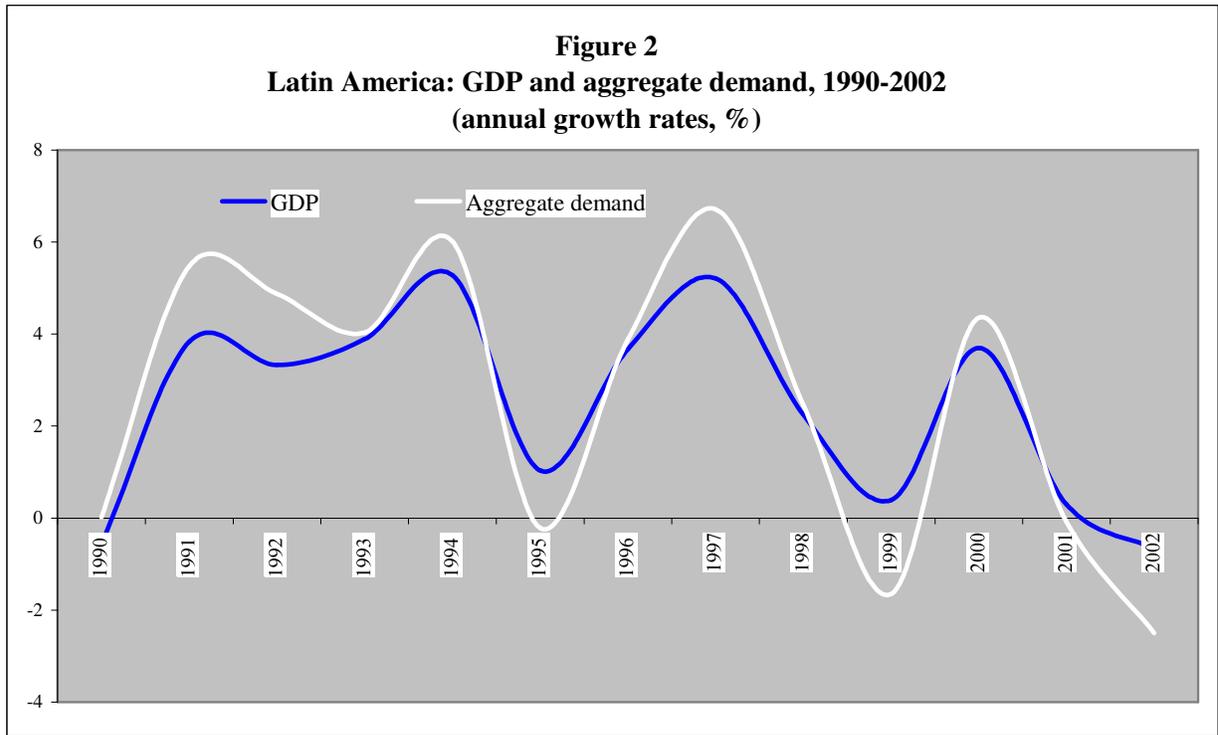
^a Provisional figures.

^b In each period, each country's GDP was weighted by its share in the regional output expressed in current US dollars.

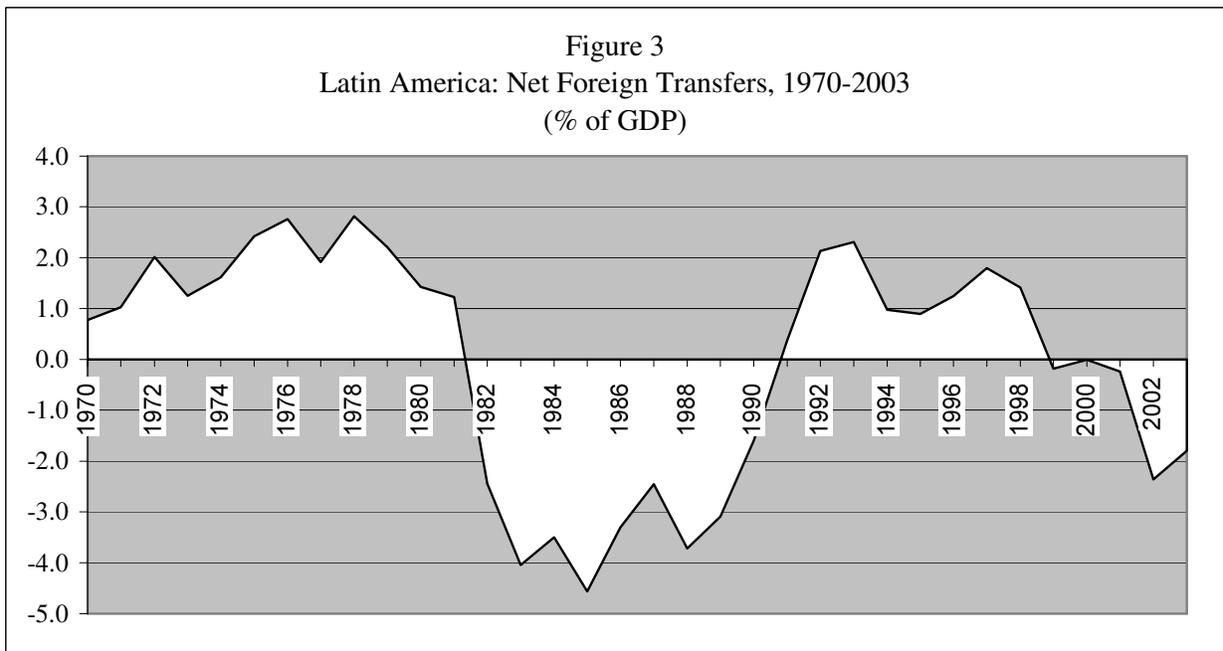
Figure 1
Latin America: Gross fixed investment, 1976-2003
 (% of GDP)



Source: Based on ECLAC figures for 19 countries, scaled to 1995 prices.



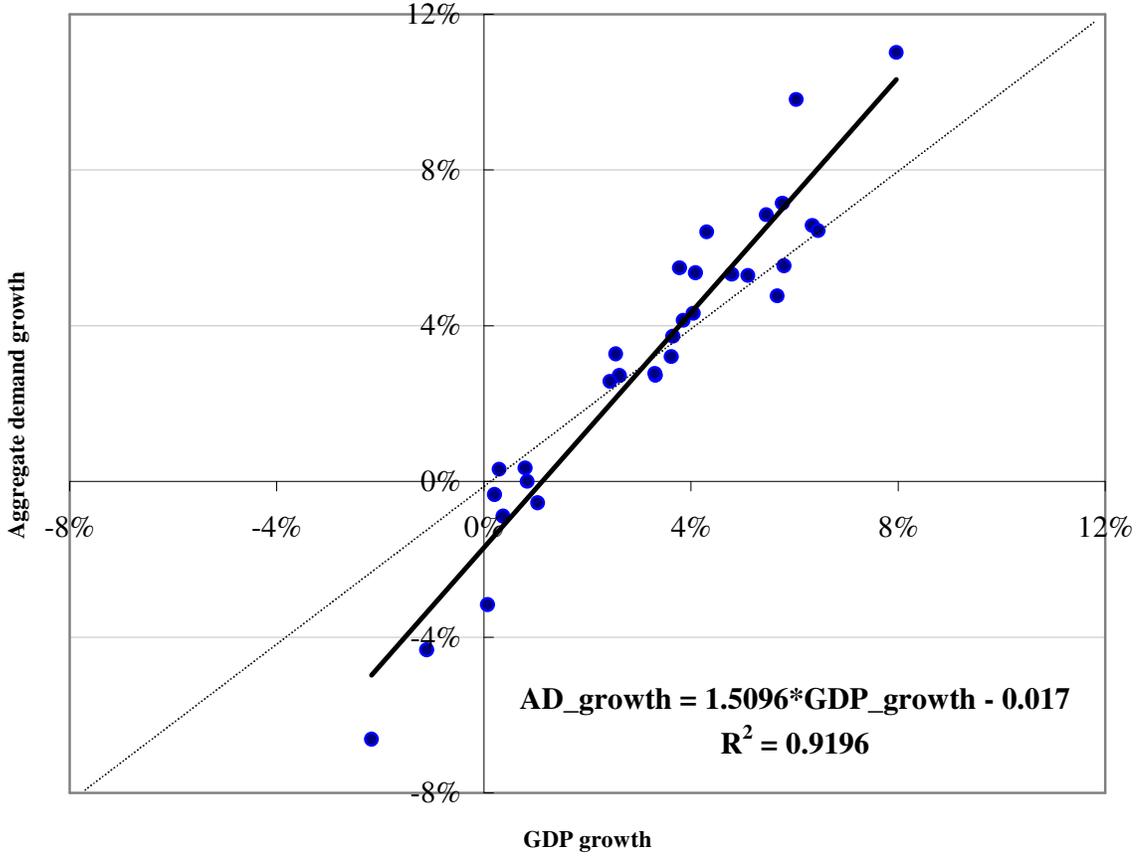
Source: ECLAC data. Includes 19 countries.



Source: ECLAC.

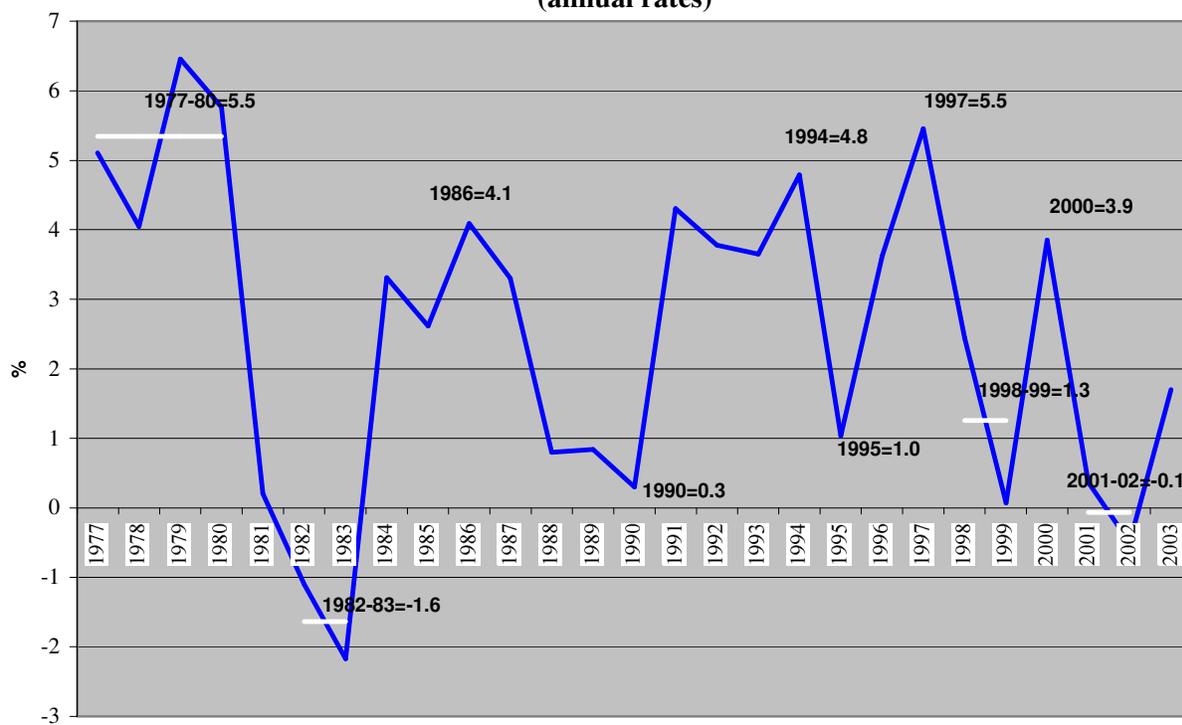
Net Foreign transfers are equal to net capital inflows minus net factor payments (interests plus profit remittances).

Figure 4
Latin America (19): GDP and Aggregate demand, 1970-2001
(annual growth rates)



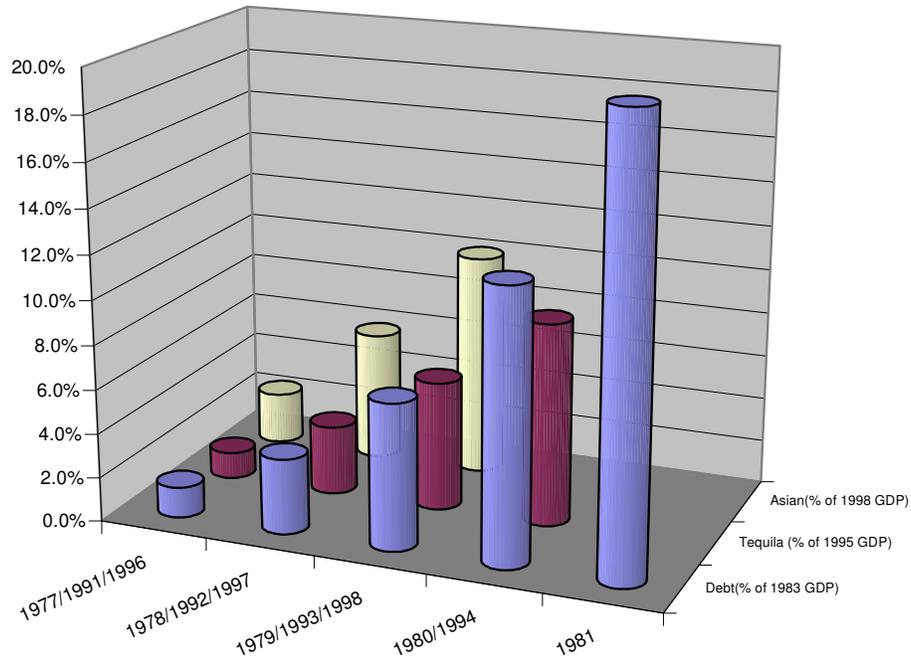
Source: author's calculations based on ECLAC data.

Figure 5
Latin America (19): GDP growth, 1977-2003
(annual rates)

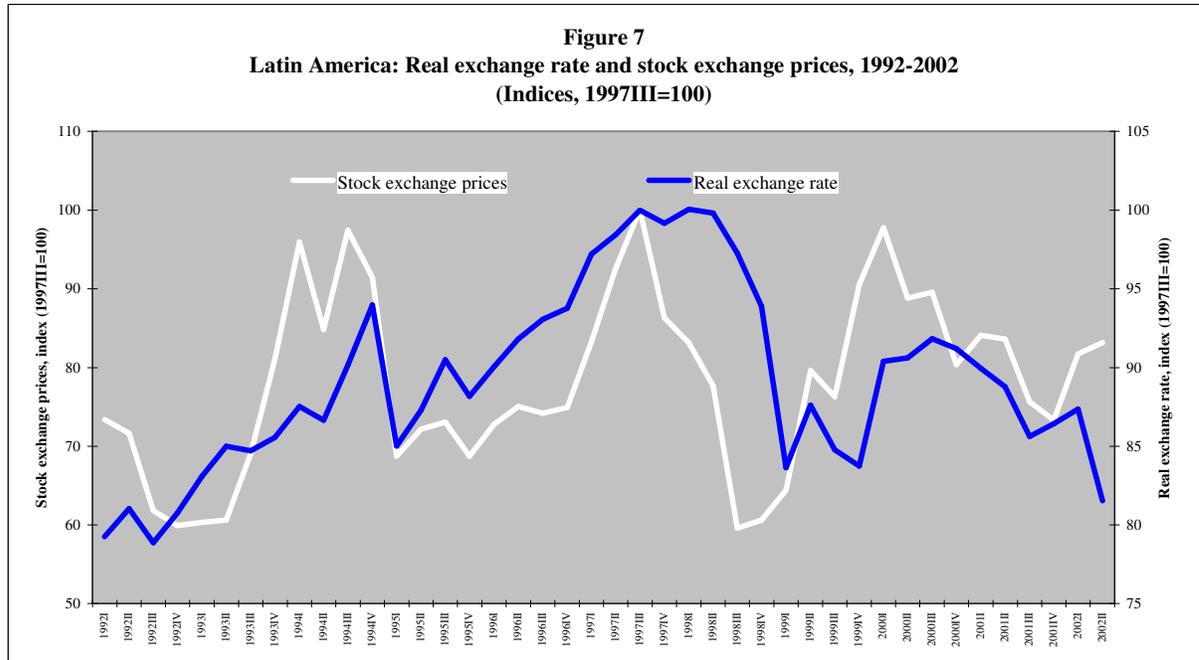


Source: Based on ECLAC data.

Figure 6
Latin America: Accumulated deficit on current account
as % of GDP in crises years



Source: Calculations of the author based on current figures of 18 LACs.



Sources:

Stock exchange prices: Expressed in an equivalent to local currencies in real terms. Based on *IFC/Standard & Poor's, Emerging Stock Market Review*, several issues. Index weighted by amount of transactions. Includes selected stock market indices (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela).

Real exchange rate index: Author's calculations. It corresponds to the rate of national currencies per US dollar, inflated by domestic CPI and deflated by an external price index. Index weighted by GDP. Includes 19 countries.