Seeking Growth under Financial Volatility

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ECLAC

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Foreword

by José Luis Machinea

This volume deals with macroeconomic issues and their relation to economic growth. It belongs to a line of research developed by ECLAC during recent years on the globalization of financial volatility, macroeconomic management, and growth.

This line of research has been encouraged by the frustrating GDP growth of Latin American economies since the 1980s. Even disregarding the so-called lost decade resulting from the debt crisis, in the subsequent period 1990–2004 growth averaged a disappointing 2.6% per year. One policy area associated to that outcome has been a short-legged macroeconomic environment, detrimental for both capital and labor performance. It has been dominated by highly unstable aggregate demand and misaligned exchange rates, frequently far away from trend levels. These imply an "unfriendly" environment for investment decisions, commonly with "wrong" prices for an efficient resource allocation. Our purpose in this volume is to analyze policy measures that contribute to avoid costly mistakes and to recover economic growth. We build on the reforms already made, making *reforms to the reforms* when necessary. We seek to achieve a *macroeconomics-for-growth*, or *real macroeconomics*.

This new book is the result of a research project coordinated by ECLAC, supported by the Ford Foundation, on *Management of Volatility, Financial Globalization and Growth in EEs,* studying the gestation and bust of the Asian crises and the contagion experienced by Latin America. Additionally, the country cases of Korea and Malaysia in East Asia under the Asian crisis, and of South Africa in the post-apartheid period were analyzed. These three countries exhibit features that make them especially relevant.

Capital flows have been at the core of the financial crises, macro-instability and, in general, the poor growth performance of EEs in recent times. The demand for "accountability" has grown recently, activated by the fact that, in the last seven-year period (1998–2004), the Latin American economies (LACs) grew only 1.7% per year on average and per capita GDP stagnated.[1] The growth performance of South Africa is also dismal, though the causes are more complex than in Latin America. The six main East Asian countries performed somewhat better over that period, with a 3.3% average GDP increase, where the Republic of Korea and Malaysia stand out as two dynamic outliers. This average is, however, well below the 7 or 8% rates of their previous historical performance. In both regions, real macroeconomic instability – in terms of aggregate demand, interest rates and exchange rates – has been present in an outstanding fashion. In fact, in these recent crises sharp gaps between actual and potential GDP and outlier exchange and interest rates have been recorded. Actual total factor productivity has contracted and the supply of physical and human capital has been discouraged. Several EEs have stepped down to lower growth paths; from Argentina, to Korea, to Malaysia or Chile.

Firms and labor, as well as tax proceeds, have been hit by real macroeconomic instability. Extreme macroinstability has been associated with strong swings in aggregate demand. For instance, all across-the-board changes in Latin American economic activity have been led by fluctuations in aggregate demand; the sharper swings in GDP have been endogenous to those changes in aggregate demand, all of which have been driven by capital surges. The recessive adjustments in East Asia in 1997–98 were also led by reversals of capital flows, which followed the voluminous previous inflows.

Of course, out-surges are not the only relevant variable; there are other international variables and many country specific, economic and political, variables playing around. However, for the Latin American region as a whole, capital account cycles have been notably strong compared to any combination of other domestic or external variables. The sudden stops in capital flows have been located mainly in flows other than greenfield foreign direct investment (FDI), and have largely been associated with the behavior of the private sector, rather than the fiscal accounts. We show that the private sector response has been, frequently, misled by a procyclical bias in macroeconomic policies.

We are convinced that the present volume is a significant contribution to this crucial concern of ECLAC: to develop a market economy capable to growth in a sustained way, in which both productivity and

[1] We include, in these averages, estimates for 2004 that was a year of recovery, the best since 1997 for the majority of LACs; South Africa and East Asian economies also exhibited significant recovery in 2004.

the welfare of people expand persistently, and are distributed in a growingly more equitable fashion. That is why we are highly indebted with the authors of the chapters of this volume and, particularly, with Ricardo Ffrench-Davis, the coordinator of this project.

José Luis Machinea
Executive Secretary
ECLAC

Preface

by Ricardo Ffrench-Davis

Development is a complex process, and few countries have been successful in a sustained fashion. An efficient combination of macro and meso or micro policies is required; just missing one significant ingredient can lead to failure. Domestic efforts are crucial, but also the external environment is most relevant. Our main concern is the effect on growth and equity, the two crucial joint objectives of economic policy. The aim is to develop a growing, better functioning economy, in which both the productivity and the well-being of people will increase. How do capital stock, capital formation and labor markets react to changes in capital flows and the macroeconomic environment? How does overall productivity evolve and how is it distributed among people? How can alternative macroeconomic approaches contribute to build equity into the economic system and thus achieve growth with equity? What are the key variables behind the time span of adjustment and how different markets respond? Some of these concerns are addressed in this book.

This policy-oriented research follows a solid line of work of ECLAC on macroeconomics, capital flows and the nexus with growth. Two related institutional books, published in recent years by ECLAC, are: (i) *Growth with Stability,* a contribution to the 2002 Monterrey International Conference on Financing for Development, and (ii) *Globalization and Development,* which was the central issue of the twenty-ninth session of ECLAC, held in Brasilia in 2002. A number of specific projects have dealt with these issues. Three of them are:

(i) *Capital Flows and Investment Performance* (published by OECD/ECLAC in 1998), a research conducted jointly with the OECD Development Centre, that examined the behavior of capital formation in Latin America in response to the capital surges of the 1990s.

(ii) *Financial Crises in "Successful" Emerging Economies*, supported by the Ford Foundation and published by the Brookings Institution Press in 2001, studied the emergence of financial crises in four "successful" emerging economies (EEs). The analysis focused on two Latin American (Chile and Mexico), and two Asian countries (Republic of Korea and Taiwan Province of China).

(iii) *From Capital Surges to Drought* (a Palgrave/WIDER publication, 2003), which was the output of a joint project of ECLAC with the World Institute for Development Economics Research (WIDER) of the United Nations University. This research focused mainly on the analysis of agents supplying external funding since the Asian crises.[1]

This new book is the result of a research project coordinated by ECLAC and supported by the Ford Foundation on *Management of Volatility, Financial Globalization and Growth in Emerging Economies*, studying the gestation and bust of the Asian crises, the contagion experienced by Latin America, and policy responses. Additionally, the macroeconomic experiences of Korea and Malaysia in the East Asian crisis, and of South Africa in the post-apartheid period were analyzed. All three countries exhibit features that make them especially relevant.

We chose to focus on emerging economies and issues that can provide relevant lessons for Latin American countries. We have selected six papers of the ECLAC project for this volume. One paper deals with the links between macroeconomic and meso or microeconomic policies, and the nexus between long-term and short-term effects, in the search for a better macroeconomics for productive development. Several LACs have been performing ambitious reforms of their pension systems. There are numerous studies of the reforms in themselves, on fiscal implications and impact on domestic capital markets. However, research on the macroeconomic implications of the regulation of investments of pension funds, particularly overseas, is notably scarce. Another paper focuses in this issue, first in general analytical terms, and then takes the paradigmatic case of Chile, country with a deep pension reform that is a quarter of a century old.

Some countries made innovative macroeconomic reforms by introducing market-based prudential regulations of capital inflows. Two

[1] Among other issues, it examined bank lending criteria, multinational banks, prudential supervision experiences, derivative markets, the behavior of risk-rating agencies, and explored some domestic counter-cyclical policies in EEs.

such cases are illustrated by Colombia and Chile in the 1990s; one paper makes a comparative analysis of these two LACs. We selected three non-LAC emerging economies: Korea, Malaysia and South Africa. One paper compares the outstanding differences as well as similarities in the approaches adopted, by Korea and Malaysia, after the explosion of the East Asian crisis; both countries, after a period of orthodox recessive adjustment, applied sharp positive macroeconomic shocks. Another paper focuses on South Africa, that followed an approach rather in line with the Washington Consensus in a few years before the end of apartheid and strengthened that approach afterwards, particularly in relation to macroeconomic and trade policies.

The introductory chapter, by the project coordinator, discusses four issues relevant for macroeconomic balance and growth in emerging economies. First, it examines the potential contribution of capital flows to economic convergence between EEs and developed nations, and compares it with the actual growth outcome. Latin America is found to have diverged, not only during the "lost decade" of the 1980s, but as well during the subsequent decade and a half. Second, channels linking financial crises with slack growth are set out; how countries hit by crisis tend to move to a lower growth path; the intensity of the downward adjustment depends on how deep is the penetration into *vulnerability zones* during the "good" or boom years: intensity of exchange rate appreciation, short-term shares of external liabilities, currency mismatches are examples of sources of vulnerability (real macroeconomic imbalances, in our terminology). Third, it analyzes the reasons why, during capital surges, financial capital continue to flow into EEs that display mounting vulnerabilities; the leading procyclical role of short-termist agents, both domestic and international, is emphasized. Fourth, two alternative definitions of macroeconomic balances are discussed. The prevailing "neo-liberal" or "orthodox" definition based on purely financial macroeconomic balances (principally, low inflation and balanced fiscal budgets), is contrasted with an alternative approach based on comprehensive balances, that explicitly include an economic activity close to the production frontier (potential GDP), "right" exchange rates and sustainable external balances; that is, "macroeconomic balances of the real economy". A fiscal approach based on structural balances is a new significant facilitator for achieving those real balances. The research confirms that the adoption of a reformed macroeconomic approach is one crucial ingredient for correcting the severe "growth frustrations" experienced by many EEs.

Chapter II, by José Antonio Ocampo (Under-Secretary General for Economic and Social Affairs of the United Nations and former Executive Secretary of ECLAC), tackles the issue of Latin America's frustratingly low economic growth, notwithstanding the deep market reforms implemented during the 1990s. The new development strategy – including across-the-board trade and financial liberalization – was effective in reducing inflation, bringing budget deficits under control, generating export dynamism, attracting FDI and increasing productivity in leading firms and sectors. Nonetheless, economic growth has been frustratingly low and volatile, with frequent balance-of-payments disequilibria or crises, and persistently depressed domestic savings and investment. Overall productivity performance has been poor, largely because of a significant underutilization of physical capital and labor. Increasing productive and labor market dualism has become one of the most outstanding effects of the reform process, where the expansion of a segment of "world class" firms coexists with rising unemployment and labor market informality. This paper examines the growth record of the reform period in the light of both macroeconomic and sectoral (mesoeconomic) performance, and discusses the links of macro and meso policies with growth performance. Ocampo offers a "structuralist" interpretation and puts forward policy proposals.

One outstanding feature of structural changes has been the reform of pension systems. In chapter III, Roberto Zahler (President of the Central Bank of Chile from 1991 to 1996 and international consultant), focuses in the macroeconomic implications of private pension funds and their role in the transmission of external shocks.

Most analyses of pension fund portfolio diversification take as given the macroeconomic context in which they are inserted, and focus on the microeconomic conditions under which returns are maximized and/or risk minimized. The analysis of the macroeconomic implications of pension funds is usually limited to their long-term impact, specifically on savings. Zahler explores some of the short-run macroeconomic implications in EEs, based on the Chilean experience, where a reformed fully-funded system has been in place for over two decades. The analysis suggests that the size of the Chilean pension funds and the degree of concentration of that industry imply that they can have strong effects on the foreign exchange and domestic financial markets, thus altering the macroeconomic environment. This could feedback on less employment and/or lower wages, consequently affecting overall welfare, the labor market and the future benefits of workers as pensioners. In particular, he argues that the costly macroeconomic adjustment of 1998–99 was aggravated by the Chilean pension funds pro-cyclical behavior of their investments abroad. The chapter concludes that the signilicant weight achieved by institutional investors is such that, in emerging economies, public regulations governing their portfolio decisions should consider not only microeconomic matters, but also issues of real macroeconomic stability and growth.

Chapter IV, by Ffrench-Davis (Principal Regional Adviser of ECLAC and Professor of Economics, University of Chile) and Leonardo Villar (member of the Board of the Central Bank of Colombia and Professor of Economics, Universidad de los Andes), presents a comparative analysis of the macroeconomic policies of Chile and Colombia during the 1990s; in particular, it considers their exchange rate regimes, capital account regulations, and the genesis and management of financial crises. In 1995, when contagion from the tequila crisis was spreading through Latin America, both countries were exempt from contagion and recorded high rates of economic growth. Many analysts attribute this positive performance to their having undertaken a comprehensive set of prudential measures to avoid excessive exposure to short-term capital flows and pressures toward excessive real appreciation. In fact, both countries were using a market-based reserve requirement on short-term inflows, crawling-bands, and other instruments for reducing domestic vulnerability to capital flows. Despite the fact that short-term debt represented only a small share of foreign debt in both countries, after the Asian crisis vulnerability to international shocks was rather significant. In both nations, real interest rates rose sharply in 1998 and GDP growth was negative in 1999; outflows associated to short-term external debt were small, while outflows by domestic residents, via institutional investors, were very sizable, as also documented in the chapter by Zahler, and had significant recessive effects on economic activity. The similarities between Chile and Colombia, however, do not go much further. During the 1990s, average GDP growth rates were very high in Chile and posted fiscal surpluses and high private savings, while in Colombia average GDP growth was below historical levels, and there was an increasing fiscal deficit and falling domestic savings.

Chapter V reviews the post-crisis macroeconomic adjustment and the impact of policy responses on the real economies of Korea and Malaysia. In both countries, the gestation of the crisis was rather similar to that of LACs, notwithstanding that their fundamentals – rates of GDP growth, of capital formation and of domestic savings – were notably superior. Both economies opened their capital accounts in a situation of plentiful international supply of funding. Given their evident sound economic fundamentals, these countries attracted huge inflows with outcomes rather similar to those of LACs in the same circumstances: real exchange rate appreciation, external balance deficits, rising short-term foreign liabilities, increasing price/earnings ratios in stock markets. Both countries suffered under the Asian financial crisis, with GDP drops of 7% in 1997. Initially, both applied restrictive policies, subsequently their policy responses were quite different in several respects. Korea sought liquidity assistance from the IMF, which obliged it to implement a structural adjustment program, while Malaysia was able to recover policy independence in the process of crisis resolution. Korea and Malaysia adopted diametrically contrasting policies on capital flows in response to the crisis. Korea drastically liberalized its capital account (however, keeping some restrictions on capital outflows by residents) with a floating exchange rate regime (although with a huge accumulation of reserves during recovery), while Malaysia imposed stringent capital controls and returned to a fixed (but devalued) exchange rate. However, both countries, to face recession in 1998, made a swift change toward a sharp expansionary macroeconomic policy stance, based on vigorous expansive fiscal and monetary policies. This contributed to an economic recovery, in 1999, notably faster and stronger than in other EEs. The positive role of counter-cyclical macroeconomic policies in post-crisis recovery raises the question of whether the initially tight monetary and fiscal policy was kept for too long and, therefore, deepened the crisis in Korea and Malaysia. The experiences of these two economies, and their management of the aftermath of the crisis appear to be extremely relevant for LACs.

Chapter VI examines macroeconomic policy and performance in South Africa since the transition from apartheid to democracy in April 1994, which opened the way for re-integration into the global economy. After a decade of democracy, annual growth averaged 2.7%, official unemployment was over 28% and there had been little reduction in the high inequality inherited. It is argued that the poor performance in the real economy has been linked with the policy emphasis on purely financial stability, in particular lowering the fiscal deficit to below 3%, and using interest rates to lower the inflation rate to the target range of 3–6%, with little regard to the cyclical changes of aggregate demand and macro prices. The paper outlines how the political economy of the transition to democracy produced this policy stance and the process of external liberalization that guided it. It then traces the evolution of fiscal, monetary and exchange rate policies over the decade, and shows that notwithstanding their "success" in achieving domestic financial objectives (low inflation and fiscal discipline), instability was simply transferred to the external account, in the form of three foreign exchange crises and to the real economy via unstable aggregate demand and macro-prices. With productive investment further reduced by low confidence and savings depressed by rising consumption propensities – both linked to the transition – the prospects for sustained growth remain poor.

We appreciate the active participation of authors and invited specialists at two international seminars, conducted in 2002 and 2003, at ECLAC headquarters in Santiago. We acknowledge the valuable support of the Ford Foundation and the intellectual encouragement from Manuel Montes. As usual, ECLAC provided a stimulating environment for a most fruitful discussion. Heriberto Tapia gave highly professional support in revising the analytical and empirical content of drafts of all chapters. Lenka Arriagada and Marcela Osses were exceptionally efficient in the preparation of the final typescript. Naturally, all the opinions set forth here are the sole responsibility of the respective authors.

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