

# Part I

## Latin America: How to Achieve Stability and Growth?



# 1

## **Changing Expectations, Capital Surges and the Banking Sector: Argentina, Brazil, Chile and Mexico in the 1990s**

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The financial crises in 1994-95 and 1997-98 in developing economies led to an overall cry for improvements in regulation and supervision of the financial sector, in particularly of the banking sector. In addition, further privatisation and opening of domestic financial markets to foreign banks was recommended as a way to increase both stability and efficiency of credit provision by domestic banks (e.g. Burki and Perry, 1998). In Latin America, several countries followed such recommendations and their financial regulation and supervision have improved significantly.

Despite these changes, the crisis of 2001-02 in Argentina (where after 1994 the strictest bank regulation was introduced) indicates that the Latin American banking sector remains fragile. In addition, the problem of credit stagnation became more acute after 1997-98 (Barajas and Steiner, 2002). Thus it has become evident that additional measures are required to achieve growth and stability of the banking sector in the region – so that the sector can make a significant contribution to the long-term development of the region.

Explaining the fragility of the Latin American banking sector requires an integrated macro- and microeconomic analysis. In the 1990s, the interaction of macro- and microeconomic imperfections

generated bank crises and resulted in the boom-bust character of credit provisioning in the region. We must consider that financial activity is almost by definition forward-looking, and highly influenced by changes in expectations. Banks tend to be highly procyclical (see e.g. Borio and Lowe, 2000; BIS, 2000), whereas their risk-taking is limited by regulation.<sup>1</sup> Bearing that in mind, the 1990s seem to be a particularly interesting period to examine how the banking sector behaves (and how that behaviour affects macroeconomic performance), because it is a period of profound changes in regulation and in macroeconomic expectations.

This chapter explores in a preliminary manner these issues (with special emphasis on the period after the Tequila crisis). It builds on research currently undertaken in ECLAC and in particular develops some of the issues raised in a recent paper (Stallings and Studart, 2002). Section 1 briefly describes the main changes in the macroeconomic environment and in regulation of the Latin American banks between the end of the 1980s and the beginning of 1990s (particularly in Argentina, Brazil, Chile and Mexico) and their relations with bank performance and crises in the period. Section 2 deals with the regulatory and microeconomic changes after the Tequila crisis. Section 3 shows how banks reacted to the new regulatory and macroeconomic environments. Section 4 summarises our findings and presents our conclusions.

## **1 Exuberant Expectations, Surges of Capital Flows, Policy Regimes and the Banking Sector in the 1990s**

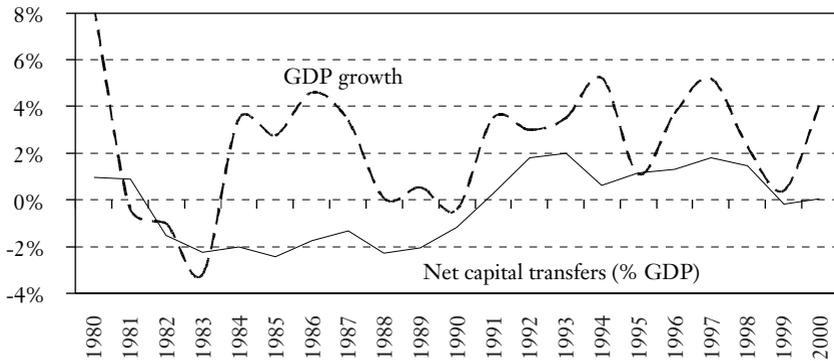
In the first half of the 1990s, there was a spectacular expansion of financial markets in the developed economies.<sup>2</sup> A significant surge of

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<sup>1</sup> This problem goes beyond the usual asymmetric information problem and has to do with at least two processes: Waves of optimism in the banking sector lead to credit expansion, which increases aggregate demand and affects income and cash flow of consumers and the productive sector. In times of expansion, real and financial asset prices increase, and so does the value of collateral. Through these self-fulfilling processes, banks tend to increase their leverage and thus their vulnerability to changes in the variables that affect their risks: economic activity and level of employment (credit risk), borrowing interest rates (liquidity risk), and asset prices (market risk).

<sup>2</sup> For an analysis of the causes and the consequences of the expansion of financial markets in developed economies, see e.g. Fornari and Levy (1999).

**Figure 1 Latin America: Net Capital Transfers and GDP Growth**  
(percentage of GDP)



*Source:* Elaborated by the author based on data from ECLAC.

capital flows to developing countries followed; capital flows more than tripled from 1991 to 1995.<sup>3</sup> These flows have only been a fraction of those between mature economies, but are large compared to the size of developing economies and their domestic financial markets.

The buoyancy in the international markets certainly influenced economic policy and economic performance in Latin America in the late 1980s and the early 1990s. Almost a decade of balance-of-payments constraints and net negative resource transfers (see Figure 1) had led to very poor macroeconomic performance and high inflation in Latin America. Now, the surge of capital inflows significantly surpassed the needs to finance both the current and the capital account, generating systematic accumulation of reserves, and removing the external constraint for the expansion of domestic demand and imports. Using these exceptional external conditions, many countries in the region adopted some type of exchange-based price stabilisation programmes, including fixed or pegged exchange rates and trade liberalisation – that were effective in reducing inflation (Table 1). Generally, the higher the inflation and the worse

<sup>3</sup> Even though country-specific features did affect the distribution of such flows between developing economies, the push factors, related to the changes in financial markets in developed economies, seem to be the most important factor in explaining such growth (Studart, 2001a).

**Table 1 Selected Macroeconomic Indicators**

	Argentina	Brazil	Chile	Mexico	Latin America
<i>Growth (% GDP)</i>					
1980s	-1.1	1.7	2.9	1.9	
1990s	4.1	3.1	6.6	3.5	
<i>Inflation (%)</i>					
1980s	451	348	20	65	
1990s	9	181	8	18	
<i>Fiscal surplus or deficit (% GDP)</i>					
1980s	-3.4	-8.4	0.3	-8.1	
1990s	-1.1	n.a.	1.4	0.1	
<i>Current account (% GDP)</i>					
1980s	-1.8	-2.0	-6.5	-1.2	-2.0
1990s	-2.6	-2.0	-2.9	-3.6	-2.8
<i>External debt (% GDP)</i>					
1980s	46	37	82	52	50
1990s	40	31	45	38	41
<i>Implicit income elasticity of imports</i>					
1980s	10.5	-0.1	0.5	1.7	0.0
1990s	4.7	5.3	1.6	2.6	3.4

*Source:* Elaborated by the author based on data from ECLAC.

the economic performance in the 1980s, the more rigid were the exchange rate regimes adopted.

Argentina, for instance, had hyperinflation and negative average GDP growth in the 1980s, and adopted a currency board system. It was effective in breaking down the inflation dynamics mainly by dollarising a significant part of spot transactions and forward contracts. Brazil – with a long history of indexation, high inflation but positive economic growth in the 1980s – adopted a pegged system and an ingenious monetary reform in 1994 (required to break up with the inflation dynamics by dismantling the main mechanisms of indexation of the economy). From 1988 to 1994, Mexico, with much lower inflation rates and slightly higher average growth rates in the 1980s, adopted a managed exchange rate regime, with devaluations that were subsequently much lower than the inflation

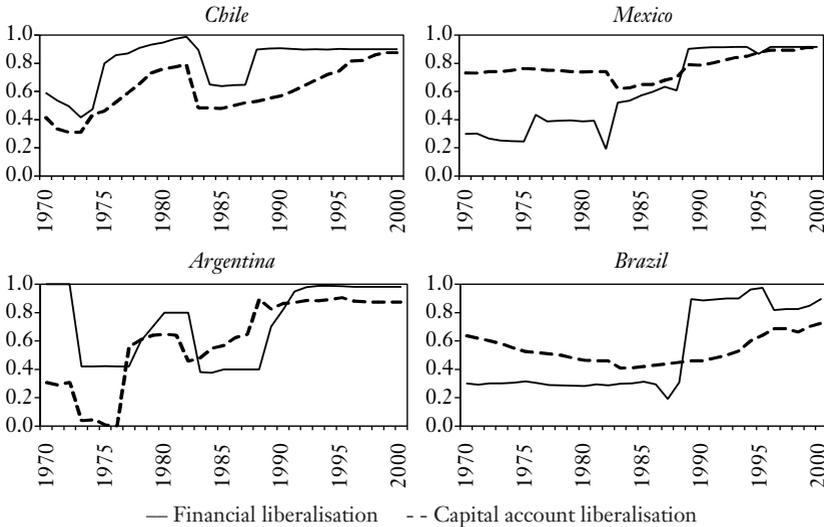
rate. Chile had already reduced its inflation to reasonable levels in the 1980s, but it still pursued a gradualist anti-inflation programme that relied strongly on overvalued exchange rates.

Exchange rate based stabilisation programmes (if associated with trade opening and significant capital inflows) often produce rapid results in reducing inflation, and also lead to positive growth rates – usually associated with rapid expansion of consumers' demand. In Argentina, Chile and Mexico, rapid reduction of inflation and positive economic growth characterised at least the first four years of such stabilisation programmes. The negative facet of exchange rate based stabilisation programmes is usually the deterioration of current account balances and accumulation of external debt, increasing external vulnerability and loss of growth dynamics after the initial years. Thus, reversals of capital flows tend to deeply affect domestic production, as domestic policymakers must respond to such reversals by increasing interest rates or adopting deflationary measures – usually through further fiscal retrenchment.

The fact that macroeconomic recovery in Latin America in the early 1990s was associated with a financial boom in developed economies is, in our viewpoint, crucial for understanding the performance of the banking sector in the 1990s. The international setting of the early 1990s was marked by rising liquidity, declining international interest rates, and increased access to the financial markets of industrial countries. This led to a surge of optimism in Latin American financial markets, and banks in particular. Given that the financial business is forward-looking by nature, changes in expectations can have profound effects on the decisions to expand credit and assume risks. The more unregulated the market, the more pronounced is this pro-cyclical bias. Therefore, in order to have the whole picture of the relation between the surges in capital flows to Latin America in the 1990s, we need to discuss the changes in regulation.

### ***Financial Liberalisation, Credit Booms and Crises Before 1995***

Figure 2 presents the financial and capital account liberalisation indexes, constructed using the methodology developed in Morley, Machado and Pettinato (1999) and regularly published in ECLAC's annual *Economic Survey*. Except for Chile, most Latin American economies went through a process of financial liberalisation at some

**Figure 2 Financial and Capital Account Liberalisation Index**

*Note:* The reform indexes are calculated by ECLAC using the methodology developed in Morley, Machado and Pettinato (1999).

*Source:* ECLAC.

point in the end of the 1980s and beginning of the 1990s. The authorities no longer set interest rates, directed credit, and captured a large share of bank deposits as required reserves, and commercial banks became free to make their own decisions on borrowers, loan volume, and prices.

Around the same time, capital account liberalisation enabled local corporations and banks to issue securities in international markets and engage in transactions in foreign currencies. In addition, in the 1990s, barriers for foreign institutions to local markets were levied. These processes of financial liberalisation *cum* capital account opening led to rapid expansion of bank credit, followed by bank and often exchange rate crisis.

We will use Figure 2 as a background for a brief description of these reforms in each of the four economies under analysis.

### *Chile*

Chile was the first to embark on a liberalisation process, beginning shortly after the military coup in 1973. Changes included freeing of

interest rates, eliminating directed credit, reducing reserve requirements, and relaxing regulation and supervision more generally. As in the other three countries, a rapid increase in lending followed the liberalisation process, ending with a banking crisis in 1981-84. The crisis forced the authorities to take immediate action, restructuring the banking sector through the intervention in 21 private financial institutions, including the two largest banks in the country. Later, 14 of these institutions were liquidated while the rest was rehabilitated and privatised again.

Soon after the crisis, policymakers introduced changes in regulation and supervision, built on the lessons drawn. The crisis thus led to a modern system of prudential regulation and increased supervisory capacity by the state. A new banking law was promulgated in 1986, encompassing a lower debt-to-capital ratio, reserve requirements according to banks' leverage position, mandatory information disclosure to the public, a partial public guarantee of deposits, restrictions on loans to "related" clients, and a strict separation between the core business of banks and their subsidiaries. After introducing restrictions, external financial liberalisation was implemented gradually, as firms were initially allowed to issue bonds and shares in external markets; later, institutional investors (banks, pension fund managers, and insurance companies) were permitted to hold external assets, while capital controls were gradually eased. In 1997, further changes included adoption of the Basel Committee's 8 percent rule.<sup>4</sup>

### *Mexico*

After a long period of recovering from the 1982 banking crisis, Mexico embarked on an ambitious new process of financial liberalisation in 1988: interest rates were freed, liquidity requirements were eliminated, credit allocation directives were abolished, and the previously nationalised banks were privatised again. The response of the banking system was almost immediate. Lending expanded rapidly (around 30 percent per year in real terms from 1989 to 1994), and the share of loans to the private sector rose from 10 percent to 40 percent of GDP (Yacamán, 2001).

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<sup>4</sup> For more details, see Budnevich (2000) and Held and Jimenez (2001).

Default rates also increased rapidly in the period – indicating reckless lending practices.<sup>5</sup> Bad lending and unhealthy macro-economic policies contributed to the build-up of the financial crisis that followed. The use of an exchange rate anchor to control inflation led to overvaluation of the Mexican peso, large current account deficits, and strong capital inflows. A significant part of these flows was intermediated by just deregulated domestic banks. These banks profited from the big differentials between domestic and international interest rates – which in turn stimulated credit growth. But when the capital flows were reversed, the stage for a twin crisis (in the sense of Kaminsky and Reinhart, 1999) was set – and it actually happened in 1994. From 1994 onwards past-due loans ratios soared with the fall of economic activity.

### *Argentina*

The Argentine financial liberalisation began at the end of the 1980s<sup>6</sup> and shared some characteristics with Mexico. Liberalisation took place in the context of an exchange rate based stabilisation programme (Plan de Convertibilidad). It lifted most of the controls on domestic and foreign operations of the domestic financial system that had been imposed during the period of high inflation and external constraints. The international financial buoyancy of the early 1990s led to a surge of optimism in the Argentine markets. Simultaneously, price stability and a fixed exchange rate regime abruptly reduced both inflation and exchange rate risk. These factors created a fertile environment for the rapid growth of financial activity, but also for increasing maturity and exchange rate mismatches.

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<sup>5</sup> As pointed out by EIU (2001) p. 7, the first years of Mexican bank privatisation were characterised by “reckless – sometimes fraudulent – lending as a result of poor supervision and underdeveloped regulations. Poor credit-analysis procedures and few internal controls characterised the sector during this time. Banks put themselves in a precarious position as their lending outpaced their deposits, and they funded the shortfall through inter-bank borrowing – mainly from foreign banks”. As a consequence, non-performing loans increased from around 2% of total loans in 1990 to 9% in 1994, prior to the peso crisis (McQuerry, 1999).

<sup>6</sup> Argentina had an aborted attempt at financial liberalisation in the late 1970s, but it was reversed as part of the overall abandonment of reforms at that time. For an analysis of the earlier attempt, see Studart and Hermann (2001, pp. 34-38).

Until 1994, recovery of the Argentine banking sector was impressive. Deposits and loans grew rapidly, while peso and dollar lending rates fell significantly, although they remained very high in comparison to those found in most developed economies and a significant number of developing economies. These results were a mix of several important features: (i) a process of monetisation, which normally follows price stability, led to a rapid growth of deposits in the banking sector; (ii) an increase of foreign capital inflows, which improved the confidence in the Convertibility Plan, raised banks' propensity to make dollar-denominated loans and borrowers' willingness to borrow in dollars, thus leading to a rapid process of dollarisation of both liabilities and assets of the banking sector; (iii) the increase of competition among banks and the improvement of overall confidence reduced banks' liquidity preference, resulting in a rapid expansion of credit. In the case of domestic banks, this increased liquidity pushed them into being less careful in their lending strategies and thus deteriorated portfolio quality.

### *Brazil*

Brazil also went through financial liberalisation before 1994, but started from a stronger initial position than the other countries. In Brazil, the initial liberalisation preceded price stabilisation. As universal banking became legal since the 1988 reform, a very rapid process of consolidation took place in Brazil's banking sector. From 1989, there was a sharp reduction in the number of commercial banks, investment banks, and finance companies, most of which became universal banks.

Following the successful 1994 price stabilisation programme, the abrupt decline of inflationary gains led banks to search new sources of income, which initially generated a rapid expansion of credit – basically through consumer and business loans. This rapid and sometimes careless expansion, the high interest rate policy, and the rising unemployment provoked a rise of non-performing loans and repayment arrears. The monetary authorities failed to restrict this credit expansion, in spite of setting very high reserve requirements. Credit expansion with interest rates that remained very high became an increasingly dangerous mix.

### *The Tequila Crisis and the Stability of the Banking System*

The devaluation of the Mexican peso in December 1994 set off a crisis that severely damaged the country's banking system and had ramifications elsewhere in the region and in the world. The effects were quite different in each of the four economies we are analysing.

The direct problems in Mexico created by the devaluation were less significant than in the other three countries, because Mexican regulations limited banks' foreign exchange exposure (although loopholes enabled banks to get around some of the restrictions; see O'Dogherty and Schwartz, 2001). There were several serious indirect problems, including a sharp drop in economic activity, a hike in interest rates, and an increase in demand for dollars. The consequence was a growing inability of debtors to service their obligations, leading to a further rise in the already high level of non-performing loans. Initially, however, the authorities thought the banking crisis would be limited in scope, because of the restrictions on foreign exchange exposure. In addition, the lack of an established regulatory authority meant that information was scarce. Thus, the approach was incremental, with solutions adopted as new problems appeared (McQuerry, 1999).

Argentina was the country in the region that was particularly affected by the Tequila crisis, and the Argentine banking system was hit hard. The currency board system in Argentina meant that domestic monetary authorities had no other instrument to face the potential capital outflows but to allow domestic rates to rise in 1995. This rise in interest rates provoked an increase of arrears and defaults, and reduced confidence of depositors, leading to significant withdrawals of deposits. Even though the Convertibility Plan had been successful for almost five years, depositors expressed their fears of devaluation by withdrawing dollar deposits. Thus, in addition to a liquidity problem, banks had to face increased exchange rate mismatching. The combination of deteriorating quality of assets and loss of deposits pointed to the vulnerable side of the seemingly solid Argentinean system. In order to avoid an open banking crisis, the Argentine Central Bank began injecting liquidity through its discount window, backed by the sale of dollar-denominated bonds – which in turn led to an increasing exchange rate exposure of the government – and by reducing reserve requirements for banks. Despite these steps, the accumulated losses of deposits were huge,

corresponding to 12 percent of the banking sector's net worth by the first semester of 1995.

The Brazilian banking crisis of 1995 stems from developments in Brazil that happened before the Tequila crisis, but this crisis clearly deepened the problems. The fundamental reasons were associated with the abrupt adjustment that the banks had to undertake due to the success of the 1994 stabilisation programme (Plano Real). During the 1980s, banks earned substantial profits from inflationary gains associated with the peculiar role of double intermediary of the public debt that the Brazilian banks enjoyed during the long period of high inflation and indexation. The abrupt decline of these gains and the high fixed costs in Brazil's banking sector initially led private banks to expand credit, which allowed the boom in consumer demand following the 1994 stabilisation programme. The number of non-performing loans and repayment arrears increased, due to rapid and sometimes careless expansion of credit, high interest rate policy, and rising unemployment. The monetary authorities failed to restrict this expansion, in spite of setting very high levels of reserve requirements. Interest rates were maintained at high levels, which made credit expansion even more dangerous. The public banks faced additional problems due to their limited capacity to restructure their portfolios (dominated by state government debt) and their high operational costs (in view of the job stability of many of their employees). The Tequila crisis was "the last straw" in a process of increasing bank problems.

Chile was much less vulnerable than the other countries for two reasons. First, its macroeconomic performance was barely affected by the Tequila crisis, due to its lower levels of external debt, strong trade balance, and sound domestic fundamentals (e.g. high growth and fiscal balance). Second, as explained above, the Chilean banking system had already gone through major changes in supervision, regulation, and structure. In fact, from 1991 onwards, bank activity started expanding at a rate that was slightly higher than that of GDP, such that the relation between loans and GDP expanded from 45 percent in 1990 to 66 percent in 1999 – much higher than the peak achieved in 1984. Other indicators also point to an improvement in the efficiency and further consolidation of the banking sector (Ahumada and Marshall, 2001: 46-47).

**Table 2 Bank Regulation and Supervision - Selected Indicators**

	Argentina	Brazil	Bolivia	Chile	Mexico	Peru	Venezuela	US
<i>Regulation</i>								
Minimum capital-asset ratio requirement (%)	11.5	11	10	8	8	9.1	10	8
Actual risk-adjusted capital ratio (%)	16.4	15.8	11.4	12.3	13	12.7	14	12
Capital stringency index	6	3	5	3	4	5	2	4
Capital regulation index	8	6	8	5	7	6	2	6
Overall bank activities and ownership restrictiveness index	1.8	2.5	3	2.8	3	2	2.5	3
<i>Supervision</i>								
Supervisors per institution	2.4	4	6	3	11.5	3.6	1	0.1
Official supervisory index	12	15	11	13	10	14	14	14
% top ten banks rated by international agencies	100	100	20	50	n.a.	50	40	100
Private monitoring index	8	8	7	8	6	8	6	8

## 2 Regulatory Changes and Bank Performance after the Tequila Crisis

The Tequila crisis set the course for profound changes of regulation and supervision in Latin America – changes which were perceived as a *necessary* condition<sup>7</sup> to avoid future similar bank difficulties (Livacic and Sáez, 2000). The speed and depth of the changes in regulation

<sup>7</sup> We emphasised “necessary” because we want to make the point until the end of this chapter that such improvements in regulation and supervision were necessary, but not sufficient to mitigate the instability problem. In addition, we will argue that in some cases the more stringent regulation made the problem of credit rationing more acute in those economies.

and supervision varied with the information available to authorities, their perception of the severity of the problems confronting them, and the instruments they had at hand. Table 2 provides some indicators, using a database built in 1999 by the World Bank (see Studart and Stallings (2002) for a detailed analysis).

Chile stands out as completely different from the other three countries, because the Tequila crisis had almost no impact on the banking sector. It shows the importance of Chile's earlier steps in cleaning up the banking sector, establishing a modern regulatory and supervisory system, and maintaining comprehensive real macroeconomic balances.

In Argentina, after 1995, it became clear that, given its monetary and exchange rate regime, (i) its banking sector was highly vulnerable to changes in domestic interest rates, exchange rates, and depositor confidence; (ii) domestic banks were more vulnerable than the foreign-owned ones; (iii) since the capacity of the monetary authorities to intervene in periods of crisis was very limited under the Convertibility Plan, some additional mechanisms were needed to increase systemic liquidity (especially for dollar deposits). In order to overcome these weaknesses, an initial set of measures was introduced to restructure the sector by injecting more capital, promoting mergers and acquisitions, and creating incentives to the expansion of foreign banks. By 1997, Argentina had one of the strictest regulations in the region.

Brazil also took important steps to strengthen its banking system, but, as mentioned above, these measures were not prompted by the Tequila crisis itself. During the first three years of the successful stabilisation programme, the government promoted an in-depth restructuring of the private sector. Forty banks (of the 271 that existed in July 1994) were intervened by the Central Bank and a further 32 went through restructuring that resulted in mergers and acquisitions. In the process of restructuring, foreign banks were allowed to enter the economy. The number and participation of foreign banks increased significantly after 1995, representing a competitive challenge to Brazilian banks.

In addition to the restructuring of the banking sector, a series of complementary regulatory measures was also decreed in 1995. A deposit insurance fund was established, and capital requirements for establishing new banks were increased. Separately, new Central Bank regulations were adopted to promote accountability and avoid

bailouts, by insuring that the shareholders of institutions sold or transferred were liable for any previous wrongdoing. Perhaps the most significant of these additional measures was the law giving the Central Bank authorisation to preventatively restructure financial institutions that were not meeting system requirements or were demonstrating financial problems. As a result, 205 financial institutions have been taken over or intervened by the Central Bank since the start of the Real Plan; some 25 percent of those institutions were banks. Overall, 92 percent of these financial institutions were closed, and 65 percent of the intervened banks were closed since mid-1994. An indicator of the effectiveness of the changes was the lack of a serious banking crisis in the face of the devaluation of 1999.

By 1997, Brazil already possessed one of the strictest regulations in the region (see Table 2). An additional effort has been made to comply with the recommendations implicit in the 1988 Basel Accord and its 1995 revisions. By the end of 1994, the Central Bank of Brazil introduced minimum capital requirements along the lines of the Basel Agreement. This led to an increase in the minimum capital requirements, narrower operational limits, and the introduction of the concept of comprehensive consolidated supervision of financial conglomerates, including branches and subsidiaries abroad and non-financial firms linked to bank conglomerates as well.

Mexico moved more slowly than Argentina and Brazil in dealing with its financial crisis. Indeed, Mexico has remained in constant banking difficulties since 1995 and is still involved in a costly process of restructuring its banking system. The government set up several programmes to help recapitalise and strengthen the banks, which involved the purchase of the banks' non-performing loans to clean up their balance sheets. In addition, a number of banks were intervened and later re-sold, leading to a dramatic increase of foreign participation in the banking sector (Graf, 1999). In December 1998, new financial legislation was approved by the Congress and then implemented. Chief among the changes were: (i) a new deposit insurance system, which ended the *de facto* unlimited deposit insurance that existed previously and increased the oversight of the deposit-insurance agency; (ii) stricter accounting standards, which increased the transparency of credit operations both for supervisors and the public, imposed stricter standards for handling past-due loans, and substantially increased loan-loss provisions; (iii) a series of measures to improve lending practices and new laws on credit

transactions, aimed to speed up the process of foreclosing on assets and allow for a wider range of property to be used as collateral, and (iv) stricter rules on capital quality (EIU, 2001).

In addition, to reduce possible future exchange rate mismatching, the Bank of Mexico established stricter ceilings on foreign currency liabilities (according to banks' capital) and imposed compulsory liquidity coefficients in foreign currency according to both the size and the maturity of these liabilities (Yacamán, 2001). Banking activity declined from 1994 to 1996 (as a percentage of GDP); only in 1996 overall lending started growing again, whereas lending to the private sector only began to rise in 2000.

### **3 Macroeconomic Adjustment, Changes in Expectations and the Banking Sector in the Second Half of the 1990s**

By 1997-98, all four economies had made profound changes towards stricter regulation and supervision. Indeed, as Studart and Stallings (2002) indicate, by 1997, regulation and supervision in the four Latin American economies were significantly stricter than that of the United States (see Table 2). The processes of restructuring and privatisation of the banking sector also led to a much more internationalised and a slightly more concentrated banking sector (see appendix Table A1 and A2).

For many (e.g. World Bank, 2002), these new characteristics of the banking sector in Latin America were indications of greater competition and efficiency – which could lead to a higher supply of credit at lower spreads – and stability. This view proved over-optimistic.

#### ***Increasing External Financial Dependencies and Changes in Expectations in the Banking Sector***

While regulation became stricter, optimism about Latin America of the early 1990s declined – as is reflected in both key financial flows and prices of Latin American assets (see appendix Figure A1). The changes in expectations were highly influenced by the deterioration of economic fundamentals in the region – deeply associated with inconsistencies created by the policy regimes adopted in the early 1990s. Indeed, using excessive capital inflows and trade opening as

tools for growth and stabilisation of prices had important costs, as is well known by now.

Long-term expectations, and thus investment, tended to be highly depressed in the second half of the 1990s, as a result of the macroeconomic uncertainties and competitive pressure put on investors. In addition, consumer credit in the region is highly rationed, due to the characteristics of the domestic financial structure mentioned below. In contrast with investment, consumption responds rapidly to changes in the supply of credit.

Not surprisingly, thus, in most of the economies in the region, the growth dynamics in the 1990s were highly associated with consumption expansion (Chile again being one of the very few exceptions) and with deterioration of the current account – despite the growth of exports.<sup>8</sup> External imbalances increased, resulting in greater external financial dependency. Output and exports were growing at a pace that was lower than needed to solve the created macroeconomic imbalances.

As external dependency grew, so did the constraints on domestic policy. First, to maintain the attractiveness for international investors and domestic borrowers, monetary policy in many countries aimed to keep interest differentials high, whereas fiscal discipline was used as a tool for adding credibility to the stability of exchange rate regimes.<sup>9</sup> Thus, attracting capital flows became a crusade of the policy package, and not only of exchange rate policy.

Second, high levels of interest rates made the process of fiscal adjustment difficult and led to loss of international competitiveness of domestic corporations. It also led to volatile, low levels of economic activity (appendix Figure A2), and volatile changes in unemployment, that had an upward trend in Brazil and Chile. Given the loan structure in most Latin American banking systems, changes in unemployment are likely to affect the levels of past due loans. The level of unemployment is likely to directly affect banks' default rates, but the mere volatility of unemployment rates tends to increase the "perceived default risk" (defined as the expected variance of the levels

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<sup>8</sup> The problem lies in the rapid increase of the income elasticity of imports (Table 1, last column) caused by abrupt trade liberalisation and exchange rate misalignments.

<sup>9</sup> Of course, fiscal discipline was also required for assuring sustainable growth of aggregate demand and supply in a context of low inflation.

of past due loans), leading to a more conservative approach of the banking sector.

Third, with increased international integration of domestic financial markets and the widening of dollar-denominated liabilities and assets in a significant numbers of countries, the process of policy-induced dollarisation was a fact. The case of Argentina was perhaps the most dramatic, as the currency board significantly reduced banks' perceived exchange rate risks and stimulated them to expand their dollar-denominated loans (more on this below).

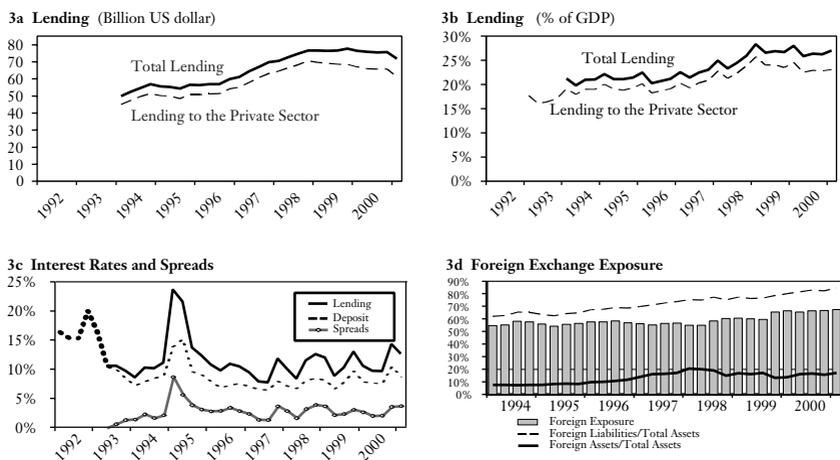
Thus, as mentioned above, stricter regulation and supervision, in the context of deteriorating macroeconomic fundamentals and expectations, directly affected the expectations and the behaviour of the banking sector – and therefore its performance in the second half of the 1990s.

### *Argentina*

In Argentina total lending and lending to the private sector had increased in dollar terms until 1998, but this trend has reversed from 1999 onwards (Figure 3a). Figure 3b indicates an even more worrisome aspect of the performance of the banking sector: total lending to the private sector as a percentage of GDP stagnated at around 20 percent, which is very low. In addition, even though the intermediation spreads were relatively low, lending interest rates remained very high (between 5 and 12 percent) (Figure 3c) – despite the increase in competition, due to the entry of foreign banks and the openness of the banking sector, and the decline of past due loans from 1995 onwards (Figure 3d).

The currency mismatches of the Argentine banking sector, which were already high in 1994-95, continued to rise (Figure 3d).<sup>10</sup> The high exchange rate exposure was at the heart of the bank crisis that happened after the 2002 devaluation of the Argentine peso. It is directly related to the initial success of the currency board and reflects the confidence of both public and bankers in the currency board. It also seems to be related to the increasing share of foreign banks in total assets of the sector. After the Brazilian real devaluation

<sup>10</sup> As measured by the relation between deposits plus other liabilities in US dollars and total assets, the level of foreign currency exposure has been increasing since the early 1990s, culminating in ratios that are over 50% in 2001 (Figure 3d).

**Figure 3 Financial Indicators for Argentina**

Source: IMF CD-ROM (September 2001).

in January 1999, depositors increasingly turned this confidence into fear of possible devaluations and a search for “exchange rate hedging”. As dollar-denominated deposits increased, domestic banks increasingly preferred to lend in dollar in order to maintain exchange rate mismatches under control.

In sum, regulation and supervision in Argentina should have improved the banking sector stability, and the sector has definitively become more efficient after 1994–95. However, the macroeconomic environment has delayed the recovery of banking activity and led to building exchange rate risks and default risks. In this context, the bank crisis that followed the devaluation of the peso was thus highly predictable (see Studart, 2002).

### *Brazil*

The performance of the banking sector of Brazil deteriorated after the Asian crisis. First of all, after the rapid growth of lending in the first half of the 1990s, lending to the private sector almost stagnated from 1997 onwards, and began to shrink in 2000 (see Figures 4a and 4b).

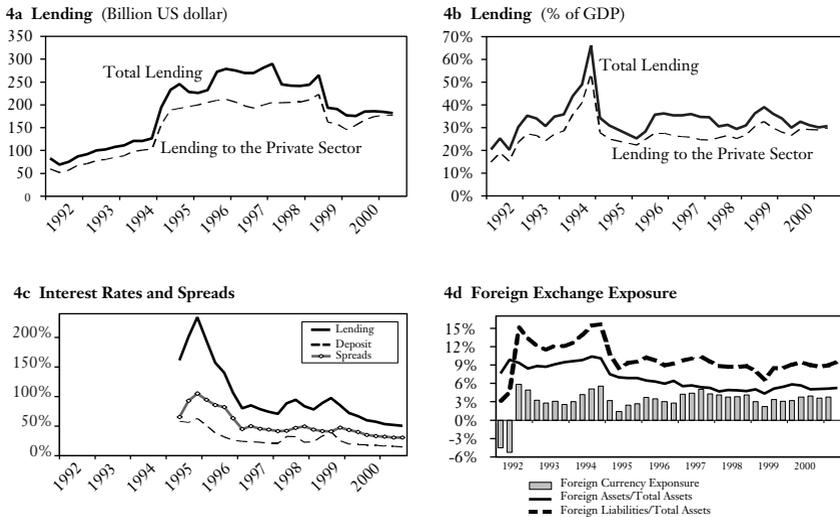
As regards the costs of borrowing, the picture is even more worrisome. Spreads in the Brazilian banking sector were outrageously large before 1994. From 1999 onwards, the Brazilian

Central Bank introduced several measures to reduce these spreads, including a significant decline in reserve requirements, reduction of taxation on bank operations and an increase of the disclosure of interest rates charged by different banks.

In addition to these measures, the Central Bank of Brazil expected that increased participation of foreign banks and stronger competition would further reduce the interest rates.<sup>11</sup> From 1995 onwards, spreads have been reduced significantly (Figure 4c). However, they seem to have stagnated at very high levels (around 30 percent) and recent Central Bank of Brazil reports indicate that they are rising slightly again.

The reasons behind these high spreads are interrelated: the remaining macroeconomic uncertainty and the high levels of past due loans. Indeed, past due loans remained more than 10 percent of total loans of the banking sector, despite the decline of past due loans since 1999 (mainly due to the brief recovery of the economy in the end of 1999 and 2000).

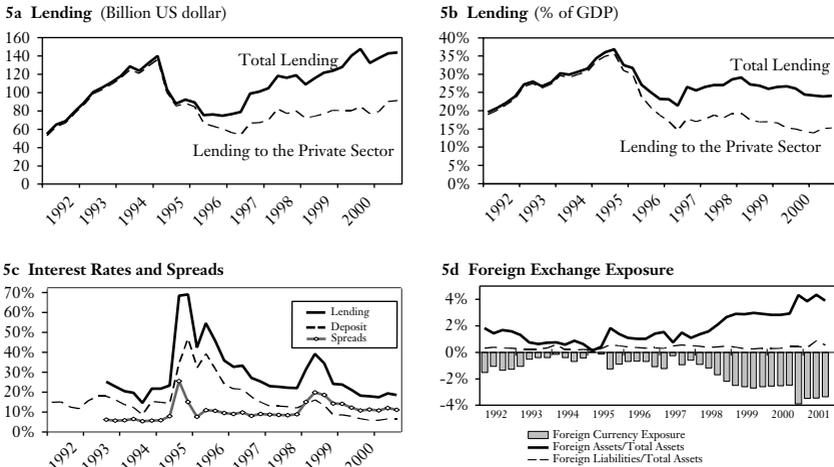
**Figure 4 Financial Indicators for Brazil**



Source: IMF CD-ROM (September 2001).

<sup>11</sup> For a thorough analysis of the main determinants of spreads in Brazil and the policies introduced to reduce them, see BCB (2000).

**Figure 5 Financial Indicators for Mexico**



Source: IMF CD-ROM (September 2001).

### *Mexico*

The case of Mexico is, in some aspects, similar to that of Brazil. As mentioned before, after the Tequila crisis, the domestic banking sector has been involved in a costly process of restructuring. Despite the good growth performance from 1996 onwards, lending to the private sector in US dollars declined significantly from 1994 to 1997 (Figure 5a). In addition, from 1994 onwards, there was not only a substantial decline in lending to the private sector as percentage of GDP, but also this percentage stagnated at very low levels (less than 20 percent) until recently (Figure 5b).

As regards the cost of borrowing (Figure 5c), even though the spreads are still very high (around 12 percent) they have declined substantially from 1995 onwards. But the fact is that, despite all the restructuring and increased competition (coming especially from the entry of new foreign banks), spreads remain high and show no clear tendency to decrease since 1999.

At first sight, this seems paradoxical given the rapid decline of past due loans from 1998 onwards. But this paradox vanishes once one takes into consideration that the Mexican economy is again facing a deterioration of its growth performance.

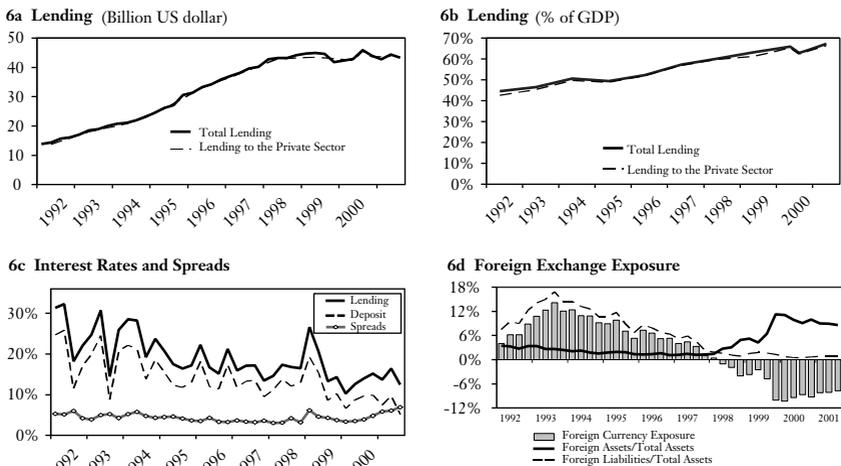
*Chile: An Exception?*

Out of the four cases, Chile seems to have performed best in the 1990s. As explained above, this had to do with the fact that its macroeconomic performance was barely affected by the Tequila crisis, and that the Chilean banking system had already gone through major changes in supervision, regulation, and structure.

Total lending and lending to the private sector have increased almost steadily from 1991 onwards, both in dollar terms and as a percentage of GDP. Private lending almost equals total lending and increased from US\$15 billion in 1993 to around US\$40 billion in 2000 (Figure 6a). Figure 6c shows a significant reduction of lending rates, while the spreads remain impressively stable until the end of 1998, increasing slightly after 2000.

Despite this good performance in the 1990s, Chile is also suffering from credit stagnation from 1999 onwards (Figure 6a). Furthermore, even though the default rates are still remarkably low, they are rising as a result of increasing unemployment.

**Figure 6 Financial Indicators for Chile**



Source: IMF CD-ROM (September 2001).

#### 4 Concluding Remarks

Banks are in the business of intermediating deposits and other types of liabilities to fund their assets – which in the case of most Latin American economies are composed of loans to the private sector, very few private bonds and government bonds. As intermediaries, they manage the risks related to the potential changes in the quality of their assets and the maturity and currency mismatches implicit in the process of intermediation.

Changes in bankers' expectations and in the structure of their liabilities tend to change their preferences in terms of the maturities and composition of their assets – and there is a good deal of evidence that banking activity is highly pro-cyclical. Changes in the macro-economic environment affect both potential access to liquidity and the structure of bank liabilities. Finally, financial regulation sets the limits of banks' risk-taking behaviour – which is directly related to the maturity and exchange rate mismatches between their assets and liabilities.

The story of the Latin American banking sector in the 1990s can certainly be explained by the set of variables described above. The significant surge of capital flows to developing countries in the first half of the 1990s was facilitated by capital account liberalisation and domestic financial liberalisation. This surge of capital flows reduced the external constraints to macroeconomic expansion and permitted the adoption of different types of successful price stabilisation programmes, often anchored on more-or-less rigid exchange rate regimes and trade opening. The improvement of growth performance and the achievement of price stability created a self-fulfilling process of rising expectations.

This rise of expectations, stimulated by optimism of international markets and by economic recovery (and often the loss of inflationary gains), also affected the behaviour of domestic banks. In the four economies under analysis, similar processes of credit expansion took place. Credit expansion combined with high lending interest rates, poor macroeconomic performance (particularly if associated with high and increasing unemployment rates) and poor regulation and supervision are a recipe for bank crises – Argentina, Brazil and Mexico demonstrated the recipe works well.

The Tequila crisis exacerbated the problems that were present previously in the banking sectors of Argentina, Brazil and Mexico, and

led to deep economic contraction, and thus higher unemployment and higher levels of past due loans in Mexico, forced abrupt rises in interest rates in Argentina, Brazil and Mexico and caused significant devaluations in Mexico. The crisis was the last straw in a process of mounting financial instability leading to a banking crisis.

The changes in regulation and supervision that followed the Tequila crisis were a response to the problems of stability faced by the bank sector in Latin America after 1994-95. They increased the “potential stability”, but to be effective these changes also required a certain stability of macroeconomic variables that directly affect intermediation risks: exchange rate, interest rates and economic growth. The stricter regulatory setting was implemented in a context of a deteriorating macroeconomic environment, which was deeply associated with the volatility of capital flows in 1997-98. As a consequence, domestic banks increasingly assumed defensive strategies as their capacity and willingness to expand credit were significantly reduced. This seems to explain partly the expansion of treasury activities (acquisition of short-term highly paid government bonds), and the credit stagnation that is plaguing these economies – including Chile.

In addition, the stricter regulation and supervision simply could not avoid the bank crisis in Argentina. This has to do again with the fact that financial regulation and supervision often serve as mechanisms to reduce excessive risk-taking by banks – in a context where the variables that determined such risks fluctuate within a narrow band. In the Argentinean case, whereas the economic recession and the high interest rates led to a rise in past-due loans (the default risk) the mere possibility of collapse of its exchange rate regime led to a simultaneous rapid increase of the liquidity risk (dollar deposit drain) and the market risk. When the convertibility collapsed, the process of financial instability that was mounting turned into a bank (solvency) crisis.

Like the Tequila crisis, the Argentinean crisis has once again sounded wake-up calls to Latin America. But this time it indicates the limits of regulation and supervision to prevent crises in a context of highly unstable macroeconomic settings and expectations.

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# Appendix

**Table A1 Indicators of Concentration in the Banking Sector**  
(share in total deposits)

	1994				2000			
	Number of Banks	Largest 3 Banks	Largest 10 Banks	HH Index	Number of Banks	Largest 3 Banks	Largest 10 Banks	HH Index
<b>Latin America</b>								
Argentina	206	39.1	73.1	756.9	113	39.8	80.7	865.7
Brazil	245	49.9	78.8	1220.9	193	55.2	85.6	1278.6
Chile	37	39.5	79.1	830.4	29	39.5	82.0	857.9
México	36	48.3	80.8	1005.4	23	56.3	94.5	1360.5
Venezuela	43	43.9	78.6	979.2	42	46.7	75.7	923.1
<b>Asia</b>								
Republic of Korea	30	52.8	86.9	1263.6	13	43.5	77.7	899.7
Malaysia	25	44.7	78.3	918.9	10	43.4	82.2	1005.1
Philippines	41	39.0	80.3	819.7	27	39.6	73.3	789.9
Thailand	15	47.5	83.5	1031.7	13	41.7	79.4	854.4
<b>Central Europe</b>								
Czech Republic	55	72.0	97.0	2101.5	42	69.7	90.3	1757.8
Hungary	40	57.9	84.7	1578.8	39	51.5	80.7	1241.8
Poland	82	52.8	86.7	1263.6	77	43.5	77.7	899.7
Turkey	72	40.7	79.1	957.2	79	35.9	72.0	710.2

Source: IMF (2001:11).

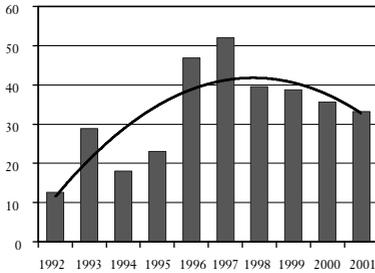
**Table A2 Foreign Bank Assets as Share of Total Bank Assets**  
(percentages)

	1994	1999	2000
<b>Latin America</b>			
Argentina	17.9	48.6	49
Brazil	8.4	16.8	23
Chile	16.3	53.6	54
Colombia	6.2	17.8	26
Mexico	1.0	18.8	24
Peru	6.7	33.4	40
Venezuela	0.3	41.9	42
<b>Central Europe</b>			
Czech Republic	5.8	49.3	66
Hungary	19.8	56.6	62
Poland	2.1	52.8	70
Turkey	2.7	1.7	n.a.
<b>Asia</b>			
Korea	0.8	4.3	3
Malaysia	6.8	11.5	18
Thailand	0.5	5.6	12

*Source:* IMF (2000: 153) for 1994 and 1999; BIS (2001: 25) for 2000.

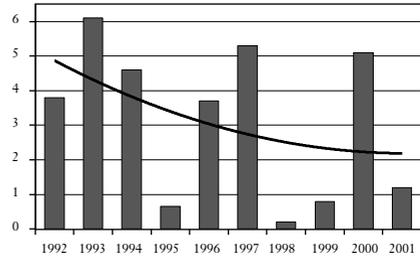
**Figure A1 Some Indicators of Changes in Expectations Towards Latin America in the 1990s**

**Latin America: Issues of Bonds in the International Markets**  
(US\$ billion; polynomial trend line)



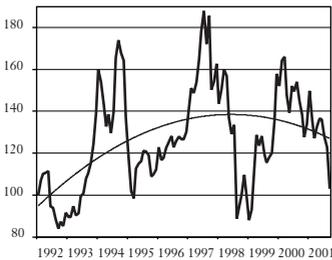
Source: Elaborated by the author based on data from International Financial Statistics (IMF).

**Latin America: Issues of ADRs**  
(US\$ billion, trend line)



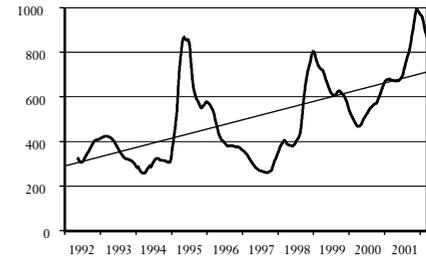
Source: Elaborated by the author based on data from International Financial Statistics (IMF).

**Latin America: Stock Exchange Index** (31/1/92=100; trend line)



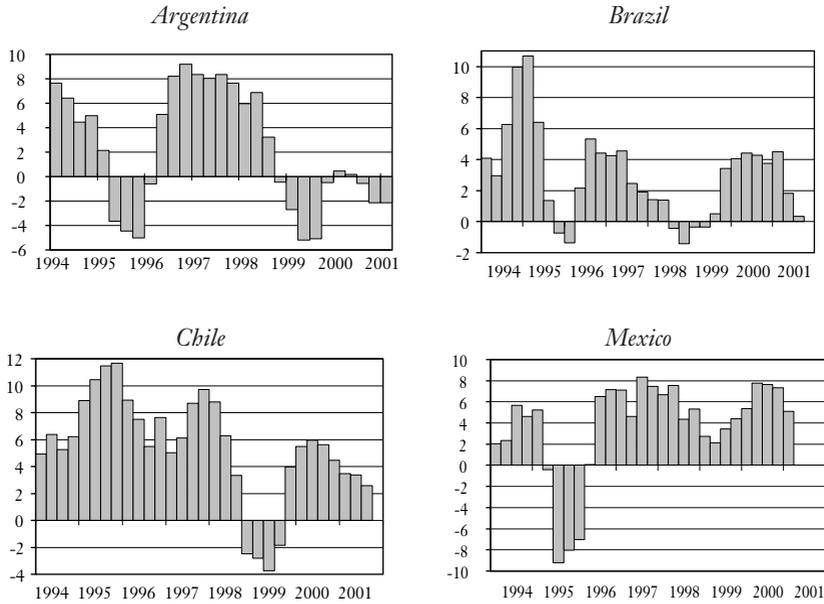
Source: Elaborated by the author based on data from IMF, Emerging Markets Division.

**Latin America: Euro-bond Spreads**  
(90 days average; Basis points over US Treasury bond rates; linear trend line)



Source: Elaborated by the author based on data from JP Morgan.

**Figure A2 Growth Volatility after the Tequila Crisis**  
(GDP growth rates)



Source: ECLAC.

# 2

## Comment on Rogério Studart

*Jürgen Stark*

The chapter by Rogério Studart focuses on the crucial issue of how to achieve stability and growth. To put it differently: what are the preconditions for sustainable non-inflationary growth? In this regard, let me quote a famous saying of a former German economics and finance minister, who once said: “Stability is not everything, but without stability everything is nothing”. This saying was originally about price stability. However, it also applies to financial stability and macroeconomic stability and in particular to developments in Latin American countries over the past few years.

By financial stability I mean sound financial institutions and the ability of markets to function well. Rogério Studart makes an important contribution to the issue of financial stability. His analysis of the banking sector of four Latin American countries sheds light on crucial topics. He thoroughly scrutinises the close links between regulation and supervision of the banking sector, changing expectations and financial cycles and macroeconomic performance. To a large degree, I share his conclusions. In particular, I agree that “the Argentine crisis ... indicates the limits of regulation and supervision to prevent crises in a context of highly unstable macroeconomic settings and expectations”.

Rogério Studart focuses on banking regulation and supervision, and in this area he has done an excellent job. However, something important is missing: the crucial role of macroeconomic stability and the related policies. Moreover, understanding the links between financial stability and macroeconomic stability is imperative for understanding developments in Latin America. In this regard – and

that is my first comment – it is important to avoid any misunderstanding. Rogério Studart talks about a trade-off with respect to stability and growth. However, one should be clear on that point. According to the “orthodox” view, financial stability and price stability are the platforms to maximise economic growth. Policies directed at exploiting short-term trade-offs between price stability and economic activity and growth, risk contributing to instability – or unsustainable inflationary growth – over longer horizons.

My second comment will be on macroeconomic policy and particularly on exchange rate policy and the liberalisation of capital movements. Argentina is a striking example in this respect. In just over a decade the country has managed to lurch from one disaster to the next. Now the economic and social situation is most precarious.

Because Argentina had one of the most strictly regulated financial sectors in the region since 1997 – as Rogério Studart correctly mentions – other policy areas are responsible for the mess, primarily exchange rate policy. The decision in 1991 to peg the peso to the US dollar was correct at that time. After years of hyperinflation, the introduction of the currency board – accompanied by an IMF-supported programme – was a successful and decisive element in the Argentinean disinflation strategy. However, while the US dollar-based currency board maximised the credibility of the commitment to price stability in the short run, it also was responsible for Argentina’s competitiveness problem. While economic and political developments worsened, Argentina was increasingly caught in a vicious circle that became inconsistent with the currency board. Following the rise of the dollar since 1997-98 and the devaluation of the Brazilian real in 1999, the peso became overvalued, resulting in protracted high current account deficits, substantial external borrowing needs and downward pressure on growth. At the same time, the priority of monetary policy to defend the exchange rate also hampered domestic growth. Briefly said, the currency board played a central role in both the initial success and ultimate collapse of Argentina’s stabilisation and reform efforts. In the end, Argentina became a textbook case for problematic exchange rate fixing.

Another – related – problem is that Argentina followed an unsustainable fiscal policy in the context of a currency board system. A “hard peg” solution requires a sound fiscal policy and a high degree of flexibility of the economy and particularly in the labour market. Although fiscal policy had started off in the right direction, the

programme was far from being successful. The fiscal regime tying the federal government and the provincial governments together remained full of loopholes. The lack of a sound fiscal framework hindered credibility and contributed to the build-up of an unsustainable foreign debt burden. Finally, a policy based on illusions ended up by defaulting against creditors.

Only in a very narrow view can the crisis in Argentina be regarded as a special case, because Argentina was the first country with a “hard peg” exchange rate system to abolish this regime under market pressure, in particular stemming from inside the country. From a broader standpoint, however, Argentina is only another example of an emerging market economy formerly adhering to a pegged exchange rate system that eventually became embroiled in a currency, debt and banking crisis. Experience has shown that fixed exchange rates may render economies whose capital markets are opening up more crisis-prone. Pegged exchange rates increase the risk of the national currency being overvalued. Moreover, fixed rates entail the risk of excessive foreign-currency debt, since under such conditions cheaper foreign loans are often not hedged against exchange rate losses. That, however, ultimately heightens the risk of a crisis. As a consequence of the most recent crises, there has been a growing trend towards choosing flexible exchange rate regimes.

Of course, financial crises are not unique to current financial systems; history is replete with banking and currency crises. The increasing integration of global financial markets in the past two decades, however, appears to have introduced some new elements and concerns. Under conditions of unrestricted capital flows, pegged exchange rate systems became increasingly crisis-prone. Admittedly, fixed exchange rate systems are viable when certain demanding requirements are met. But in the real world of policy slippages and protracted structural problems, we have to accept that these requirements will not be met in the long run. Sooner or later, therefore, the sustainability of a pegged exchange rate system will be undermined. The lesson to be learned from exchange rate regimes is that a country that has given priority to pegged rates must figure out whether or not it can keep its internal flexibility sufficiently high to enable it to make all the necessary adjustments. In particular, with priority given to fixed rates, monetary policy has to be completely subordinated to the exchange rate target. Moreover, there is not much room for fiscal policy. It has to be conducted in a stability-

oriented manner in order to maintain domestic and external confidence. Thus, a stable exchange rate is only sustainable if the corresponding fundamentals are adequately streamlined. A pegged currency alone cannot guarantee lasting market confidence.

Mexico was the first emerging market economy to go through this experience, followed by East Asian economies, Brazil, Argentina and other countries. This raises the question of why Chile, the fourth country Rogério Studart mentions, was different. This brings me to my third comment. For over a decade, this country also had a fixed exchange rate system – or to be more precise: an exchange rate band – and was successful in resisting contagion from the Mexican and East Asian crises. Of course, as we all know, capital controls constitute the difference. Because Chilean policymakers were wary of allowing large capital inflows that could eventually reverse themselves violently, they imposed capital controls on these inflows. By limiting in part the openness of the capital account, some degree of control on the exchange rate front was possible while at the same time monetary policy could be conducted with some independence. Evidence of their effectiveness is mixed. Total capital inflows were not substantially abated. Also, it was not possible to prevent a trend appreciation of over 30 percent between 1990 and 1997. More important, there has not been an appraisal of the opportunity cost of these controls given by lost investment.

The example of Chile should not give rise to misinterpretations. On the road towards capital account liberalisation, capital controls may at best act as a “temporary substitute” for still-underdeveloped supervisory and risk management systems. However, it still does not make sense to call for a reversal of the liberalisation of capital transactions. In principle, the fact that the free movement of capital contributes to the optimum allocation of resources is not open to question. But that must not imply liberalisation at all costs. More importantly, there is a clear need for an orderly process of liberalisation. Greater emphasis should be put on appropriately sequencing the process of liberalisation. Priority should be given to establishing a domestic financial market and the commensurate institutions and supervisory bodies. In the case of long-term capital flows, and especially direct investment, there is less danger of them being withdrawn in the event of economic difficulties. Therefore, liberalisation should start in this area. Opening up the market to short-term capital flows is something which should be handled with

care. This should be done more towards the end of the liberalisation process.

Recent financial crises prove that, where capital is highly mobile, the effects of bad economic policy and an insufficient framework can be much more serious now than was the case a decade ago. Therefore, crisis prevention through intensified bilateral and multilateral IMF surveillance is of prime importance. In particular, deficiencies in member countries' economic policies must be identified at an early stage. However, further-reaching IMF financial support for the process of liberalisation is neither justifiable nor necessary. In particular, the IMF should not unduly give incentives for the rash liberalisation of capital movements and later on take action to "bail out" those countries. It appears that in some cases the IMF pushed countries to speed up the process of capital account liberalisation and stood ready to bail out the country in the case of a crisis, thereby creating moral hazard. The IMF has drawn conclusions from recent crises and now requires an adequate financial supervisory structure before promoting the liberalisation of capital flows.

The crises in Argentina, Mexico and other emerging market economies are examples of the disastrous consequences the instability of macroeconomic policy has had for financial stability. Conversely, banking crises have often preceded currency crises, for instance in the Scandinavian countries or recently in Turkey. In effect, crises of all types have often had common origins: the build-up of unsustainable economic imbalances and misalignments in asset prices or exchange rates, often in a context of financial sector distortions and structural rigidities. Of course, not all corrections of imbalances involve a crisis. Whether they do or not depends, apart from the magnitude of the imbalances themselves, on the credibility of policy to correct the imbalances and on the robustness of the country's financial system.

In my fourth and last comment, I will argue that, as recent financial crises demonstrate, it is all about policy. This is particularly true in the case of Argentina, where the lack of political leadership and of a broad consensus regarding stability and sound public finances is the fundamental obstacle to reform. In a broader context, however, this is true of all emerging market economies, which urgently need strong domestic institutions. Strong domestic institutions are of utmost importance for financial stability and development. This includes, above all, an independent central bank

committed to price stability, an independent judiciary and the rule of law, a government sector that – apart from following a truly sound fiscal policy – is accountable and transparent, and last but not least efficient banking supervision. Admittedly, external surveillance by the IMF plays an important role in crisis prevention and resolution. However, the basic principle that “stability begins at home” should be taken to heart by emerging market economies (and the IMF). In this respect, Martin Feldstein was right when he recently wrote that “Argentina doesn’t need the IMF”.<sup>1</sup>

Financial stability is an important precondition for a sound economy. The significance of financial stability could particularly be demonstrated against examples of financial instability, as the social and economic tragedy in Argentina proves. However, a lesson to be learnt from developments in Argentina includes that – to end with a statement by Rogério Studart with which I fully agree – “improvements in regulation and supervision were necessary, but not sufficient to mitigate the instability problem”.

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<sup>1</sup> Feldstein, M., “Breaking the Habit: Argentina Doesn’t Need the IMF”, In: *Wall Street Journal Europe*, May 29th, 2002.

# 3

## Fiscal Discipline in Emerging Market Countries: How to Go About It?

*Charles Wyplosz*

The collapse of Argentina's currency board has been largely blamed on fiscal indiscipline at the federal and mostly provincial levels. For example, while the crisis was gathering strength in the Spring of 2001, the IMF Managing Director stated unambiguously that the problem's origin was to be found in the fiscal deficit, not the currency overvaluation:

“Argentina's programme aims at strengthening confidence through fiscal consolidation to achieve the programme's targets for 2001 and fiscal balance by 2005, while promoting the recovery of investment and output through fiscal incentives and regulatory changes. Firm implementation of the programme is needed to initiate a virtuous circle of stronger public finances, lower interest rates, and a recovery of economic activity. In this regard, it is essential that tax compliance be improved and that expenditures be contained, in accordance with the commitments under the federal pact of December 2000.

“Argentina's convertibility regime, the independence of the central bank, and the high capital and liquidity defenses of the banking system are important pillars of the country's economic strategy and have been vital in helping withstand turbulent international financial conditions in recent years. The IMF therefore welcomes the authorities' reaffirmation of their commitment to these policies.”

Horst Köhler, *IMF News Brief*, No. 01/44, May 21, 2001.

At the same time, Dornbusch articulated a similar view:

“A devaluation strategy must be considered perilous; a government that goes that way is likely to take Argentina back to 1990 but with this extra; the country will also be totally bankrupt. Not a good policy idea! [The] central issue of Argentina is the bankruptcy of the government.”

Rudi Dornbusch, *World Economic Trends*, No. 2, April, 2001.

However, his interpretation is not fully shared. Stiglitz (2002), for instance, writes:

“Did those large deficits, corruption and public mismanagement cause the Argentine crisis? Many American economists suggest that the crisis would have been averted had Argentina followed the advice of the International Monetary Fund (IMF) religiously, especially by cutting back on expenditures (including at the provincial level) more ruthlessly. Many Latin Americans, however, think that the full IMF plan would have led to an even worse crisis – sooner. I think it is the Latins who are right.”

Joseph Stiglitz, “Argentina, Shortchanged: Why the Nation That Followed the Rules Fell to Pieces,” In: *The Washington Post*, May 12, 2002.

Why do these distinguished observers, like much of the profession, disagree so sharply on such a basic question? The general public would be shocked to find out that the famously-dissenting profession of economists cannot decide whether the peso was overvalued or not, and whether Argentina’s public finances were lethally off-balance. More shocking even is the apparent inconsistency of as clear-headed a macroeconomist as Stanley Fischer, who states two views in the same text, first:

“The growth performance was based too much on large fiscal deficits, especially as the decade progressed. The deficit of the federal government averaged 1 percent of GDP in the first half of the 1990s and 3 percent in the second half.”

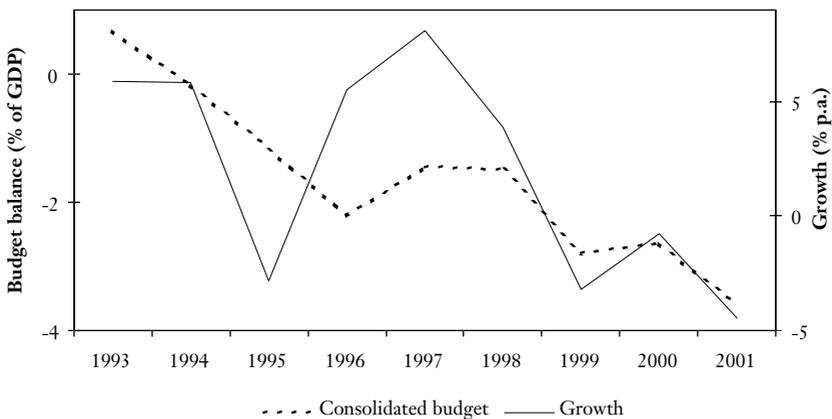
and then:

“The question that has to be asked at this time of recession is whether Argentina really needs fiscal adjustment. The obvious concern is that such an adjustment would only impede the recovery of the economy. After all, neither public debt (at around 50 percent of GDP) nor the fiscal deficit (at around 2.5 percent of GDP) are particularly high by international standards – indeed both would satisfy the Maastricht criteria, as would its inflation performance. The problem is that with the current level of spreads on Argentine bonds, the debt dynamics are on an escalating path.”

Remarks by Stanley Fischer at the Argentine Bankers Association Meeting, Buenos Aires, June 25, 2001.

Fischer would not use technical jargon, but he is describing a self-fulfilling crisis. The fiscal position was perfectly sound and would have remained perfectly safe if markets had not started to expect a crisis. The peso overvaluation prompted fears of a devaluation, which led to high interest rates. The combination of currency overvaluation and high interest rates, the classic hallmark of an excessively tight monetary policy, provoked a deepening recession. The recession resulted in declining tax revenues and a budget deficit, especially in the provinces, as Figure 1 illustrates. The rational perception that the fiscal situation was unsustainable led to increasing concerns about the currency board survival, hence higher interest rates and a worsening vicious circle that could only break out in a full-blown crisis.

**Figure 1 Budget Balance and GDP Growth: Argentina 1993-2001**



Source: Ministry of Economy, Argentina.

This description seems to vindicate both opposite views, but with the subtle nuance inherent to self-fulfilling processes. Had Argentina been growing, the budget would not have been in deficit, or the deficit would have been small enough to be accompanied by a declining debt-to-GDP ratio. The slowdown was partly due to worsening international conditions, partly to an overvalued peso. The refusal of the Argentine authorities to prepare an exit from the straitjacket of the currency board – while the economic situation was good – is the fundamental source of the crisis. It left the Argentine economy vulnerable to adverse national or international conditions. While a crisis was therefore unavoidable, its timing remained to be determined by some event dramatic enough to unleash a pressure commensurate with the hardness of the exchange rate regime. It turned out that the (mild) deterioration of public finances played this role.

Thus the real puzzle is why the budget deficit, well below levels which are considered lenient elsewhere, unleashed one of the worst crises of the past several decades. Three reasons come to mind.

First, without any monetary policy left, fiscal policy had to take up all of the burden of dealing with shocks. Worse, with monetary policy structurally excessively tight – due to peso overvaluation – fiscal policy became structurally lax. The deficit, which has been widening, would have had to widen further, with uncertain results.

Second, the fiscal record of the Argentine authorities is chequered with spectacular failures. A lack of discipline had long characterised monetary policy too. This is the reason why adopting the straitjacket of a currency board had been hailed as a positive step. Over the 1990s, the deficit has been trending downward, confirming fears that fiscal policy had become Argentina's Achilles heel.

Third, while the federal government had displayed some willingness and ability to avoid fiscal indiscipline, its ability to rein in provincial governments was increasingly in doubt. As the recession continued, the federal structure encouraged a classic free-rider problem: each provincial government had an interest in collective discipline but a strong incentive to depart from rigour. Coupled with political gaming, there was no reason to expect that the federal government would be successful in negotiating fiscal discipline with the provinces.

This interpretation of the Argentine crisis leads to a number of conclusions. The first one concerns the appropriateness of the

currency board arrangement; it will not be pursued further in this chapter. The second one concerns the dual challenge faced by fiscal policy: in the short run, fiscal policy must be available as an instrument to deal with large macroeconomic shocks while being subject in the long run to an overriding discipline constraint. This is another instance of the debate between rules and discretion. The third conclusion is that discretion in fiscal policy is more desirable the tighter is monetary policy. Countries which adopt extreme exchange rate fixity regimes (currency boards, dollarisation, monetary union membership) face a steeper trade-off between fiscal policy rules and discretion. Finally, in “federal” arrangements, such as federal states or monetary unions, the overall budget deficit becomes a matter of common concern for all “sub-federal” entities, which requires adequate safeguards, possibly in the form of legally binding arrangements or institutions.

These are the issues explored in this chapter. The debate on rules and discretions has been mainly applied to monetary policy. The result has been significant progress all over the world. From New Zealand to Sweden, and from Mexico to Poland, an increasing number of countries have made their central banks independent and entrusted the conduct of monetary policy to Monetary Policy Committees. The same principles can be applied to fiscal policy as well. I suggest that the budget deficit – not the size and structure of public spending and taxes – should be delegated to independent Fiscal Policy Committees for precisely the same reasons. I further argue that this solution is likely to enhance attempts at regional cooperation in the realm of exchange rate policy.

The next section examines the common logic of monetary and fiscal policies.<sup>1</sup> Section 2 draws some important lessons from the experience with monetary policy, recognising a number of differences between monetary and fiscal instruments. A workable definition of debt sustainability is proposed in Section 3. How to achieve debt sustainability while allowing the counter-cyclical use of fiscal policy? Section 4 presents a proposal inspired by monetary policy institutions. The link between debt sustainability and exchange rate cooperation, including the institutional aspects, is analysed in Section 5. Section 6 concludes.

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<sup>1</sup> The case for regional exchange rate cooperation is developed in Wyplosz (2002).

## 1 The Common Logic of Monetary and Fiscal Policies

Faith in the ability of macroeconomic policies to effectively erase business cycles and foster growth has long been oscillating, and it is now at a low point. During the last decade, policy activism has been rejected, increasingly replaced by rules of various kinds.<sup>2</sup> Most central banks now accept responsibility only for price stability and most governments put budget balance at the forefront of their concerns.

The sharp change from the trigger-happy 1970s can be traced back to both facts and academic research. Double-digit inflation and record levels of public debts in peace time have exposed the excesses of unconstrained policymaking. Academic research has analysed the limits of discretion.

In the field of monetary policy, the first shot has been fired by Friedman's celebrated defense of a monetary rule. Subsequent work by Lucas (1972) and Sargent and Wallace (1975) have developed the view that monetary policy is only effective if it is unanticipated. The obvious implication was that there should not be any systematic attempt at using monetary policy to support growth. Combined with Friedman's and others analyses on the cost of inflation, the conclusion has been that central banks ought to restrict themselves to delivering low inflation. More recent work, e.g. Blinder (1998), expresses doubts about the "only unanticipated money matters" view, but recognises the view that monetary policy must concentrate on inflation in the long run. Current conventional wisdom follows the view set forth *inter alia* by Svensson (1999) that central banks ought to be mainly driven by a medium-run inflation target, while carrying out counter-cyclical actions in the short run, in the spirit of Taylor (1993).

In the field of fiscal policy, a similar evolution is under way. The principle of Ricardian equivalence, put forward by Barro (1974), carries implications for fiscal policy similar to the results obtained by Lucas (1972) and Sargent and Wallace (1975) for monetary policy: Ricardian equivalence implies that fiscal policy is not an effective counter-cyclical instrument. The next step is the view that governments tend to misuse fiscal policy for short-term political

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<sup>2</sup> See "Symposium on Keynesian Economics Today", In: *Journal of Economic Perspectives*, Winter 1993 issue.

advantage (Drazen, 2000; Persson and Tabellini, 2000). The natural conclusion is that fiscal policy should not be used as a macroeconomic policy tool and should focus instead on aiming at a low and sustainable public debt. This view is now enshrined in the Stability and Growth Pact adopted by the European Monetary Union and in fiscal codes in place in various countries, in the form of multi-annual limits on spending (the Netherlands, New Zealand, Sweden, the UK and the US) or on public debts (New Zealand, Poland and Switzerland).

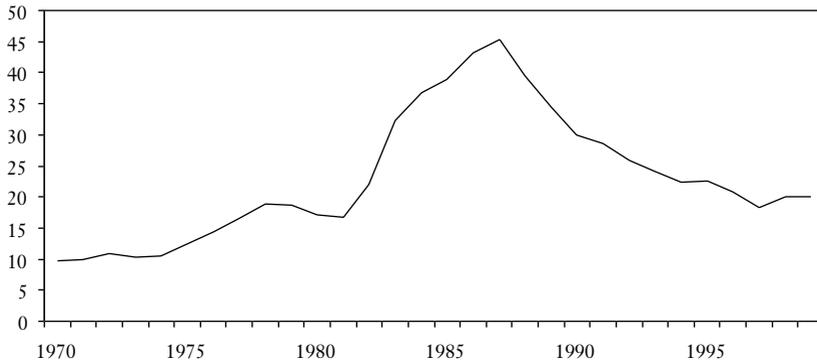
Much as strict monetary rules have been abandoned for being too rigid and arbitrary, fiscal rules are unlikely to be the final word. The next stage is to recognise the deep similarity between monetary and fiscal policies. Both have a short-run counter-cyclical role to play (the Ricardian equivalence is not found to be a robust description of how fiscal policy operates, see e.g. Bernheim, 1987, Gruen, 1991). When left in the hands of undisciplined political authorities, both produce adverse long-run effects: inflation for monetary policy, public debts for fiscal policy.

The Latin American experience is a case in point. Figure 2 shows the evolution of the overall public debt in the region. Over the 1970s, and even more spectacularly over the early 1980s, fiscal indiscipline has been the rule and public debts have exploded. Public debts have fragilised these economies, often resulting in crises and defaults. Consequently, over the subsequent decade, most countries have concentrated on bringing their debt levels down, with many successes.

Thus both macroeconomic policy instruments can be useful in the short run and dangerous in the long run. The challenge, therefore, is to combine short-run flexibility with long-run discipline. This may look like squaring the circle but considerable progress has been achieved in the realm of monetary policy. The recipe is now well-known and reasonably uncontroversial. Central banks have been made independent and given a very precise long-run mandate: price stability. Decisions are typically made by formally independent Monetary Policy Committees (MPC) who can exercise judgment but not for political expediency.

Can fiscal policy also be used as a macroeconomic instrument without necessarily bringing about deficits and a growing debt? In theory, the answer is obviously positive: deficits can be balanced over the cycle while being as strongly counter-cyclical as appropriate. The

**Figure 2 Public and Publicly Guaranteed Debt of Latin America, 1970-1999**  
(percentage of GDP)



*Note:*

The countries are: Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Salvador, Ecuador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Vincent and the Grenadines, Trinidad and Tobago, Uruguay, Venezuela.

*Source:* World Development Indicators, World Bank

challenge for fiscal policy, therefore, is to credibly combine long-term commitments with short-term flexibility.

## 2 Lessons From Monetary Policy

In comparison with monetary policy, fiscal policy is relatively ineffective. Its impact is rather slow, (too) long lasting, and uncertain (Blanchard and Perotti, 2000). The debate on Ricardian equivalence underlines that much depends on how economic agents perceive fiscal policy actions. Temporary tax measures are understood to be largely ineffective, for agents adjust their saving behaviour. “Permanent” tax measures are of limited credibility. Spending actions raise the question of how they are to be financed, which may elicit partially off-setting private reactions. In the extreme case where the debt path is seen as unsustainable, restrictive fiscal policies have been observed to exert an expansionary effect if they are seen as stabilising an otherwise explosive public debt (Giavazzi, Jappelli and Pagano, 2000).

A complicating factor for fiscal policy is that assessing the budget constraint is not easy. Governments are held accountable to deliver both explicit and implicit entitlements such as welfare payments and the retirement of future generations. This complexity cannot be fully eliminated, but the effectiveness of fiscal policy can be enhanced by improving the visibility of implicit commitments and by eliminating off-budget items.

A further complicating factor is that fiscal policy is subject to democratic oversight. Every action has to be approved by the parliament. The result is a high degree of politicisation which naturally involves differences of opinion but also open the door to lobbying by a myriad of interest groups that care little for the common public good.<sup>3</sup>

Having recognised these differences, five main lessons can be drawn:

*Lesson 1: Less activism.*

Fiscal policy is a less good instrument than monetary policy. Whenever monetary policy alone can deal with the situation, fiscal policy should remain inactive, relying only on the automatic stabilisers, certainly avoiding to become pro-cyclical.

*Lesson 2: Long-term debt sustainability ought to be a binding constraint.*

Most modern central banks are given a clear, explicit mandate to aim at price stability. The equivalent long-term concern for fiscal policy is debt sustainability, and it ought to be made explicit.

*Lesson 3: Qualified freedom over the business cycle.*

Like monetary policy, once its long-term constraint is set and serves as an anchor, fiscal policy can be used as a counter-cyclical tool whenever it can make a contribution to economic (price and output) stability.

*Lesson 4: An ability to respond in real time.*

Part of the advantage of monetary over fiscal policy is its speed of reaction. The counter-cyclical use of fiscal policy requires that the automatic stabilisers be powerful enough and, for discretionary actions, that the decision and implementation lags be sharply reduced.

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<sup>3</sup> See von Hagen and Harden (1994).

*Lesson 5: Long-term commitments must be backed up by specific legal and/or operational arrangements.*

Monetary policy is now typically subject to a clear long-term mandate via legal arrangements. The debt sustainability imperative of fiscal sustainability is rarely backed by a similar legal mandate. Europe's Stability and Growth Pact is quite unique in this respect.

### 3 Defining Debt Sustainability

Long-term debt sustainability requires that the debt level does not increase as a percent of GDP. Where it is high, the objective ought to be more demanding, calling for a decline in the debt-to-GDP ratio.

Alternative definitions have been proposed. The Maastricht Treaty, and the Stability and Growth Pact adopted by the European Monetary Union, have made popular a budget deficit target set at 3 percent of GDP. The target is highly arbitrary, the result of heavy bargaining when the Treaty was being negotiated.<sup>4</sup> The arbitrariness by itself would be of little concern if it did not make the threshold difficult to grasp by public opinions. Two recent incidents (Germany and France, the largest economies in the euro zone) well illustrate the political sensitivities at stake. More importantly, a small deficit is neither necessary nor sufficient for debt stability. The debt, as a ratio to GDP, can grow even if the budget is balanced, as it can decline even if the budget is in deficit.<sup>5</sup> Countries can default on their debts even if they have small deficits, as was the case in Mexico in 1995 and in Argentina in 2002.

Another definition of debt sustainability is that the debt should be "low". This is the definition adopted by New Zealand, for instance. But, of course, what does "low" mean? Truth is that there is no clear

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<sup>4</sup> As is well-known, the idea comes from Germany which operates a "golden rule" stating that the deficit should not exceed public investment, which presumably pays for itself. Germany has estimated that public investment averages 3% of GDP, an estimate hard to check given the imprecision of what constitutes public investment.

<sup>5</sup> If  $b$  is the debt-to-GDP ratio,  $d$  the deficit-to-GDP ratio, the evolution of the debt is given by the following formula:  $b = d + (i - n) b$ , where  $i$  is the nominal interest rate and  $n$  is the growth rate of nominal GDP.

definition of what is a reasonable public debt level.<sup>6</sup> The 60 percent Maastricht convergence criterion, for example, is an accident of history, the average debt level in Europe on the day the Maastricht Treaty was finalised. Is zero debt desirable? In principle, because taxes are distortionary, the lowest possible debt level would be desirable under the assumption that the tax burden is lower where the debt is smaller. However, there is no indication that this assumption holds in practice. In the OECD area, for instance, the partial correlation coefficient is negative (-0.03) and non-significant ( $t$ -statistics = 0.42).<sup>7</sup> Figure 3 shows nine Latin American countries for which data is available. The partial correlation coefficient is 0.08 and non-significant ( $t$ -statistics = 0.50). Another view is that the government borrows on behalf of credit-constrained citizens, which implies that some positive debt level is welfare-enhancing. Similarly, with standards of living likely to continue to rise over the foreseeable future, intergenerational equity calls for some negative transfers to richer future generations.

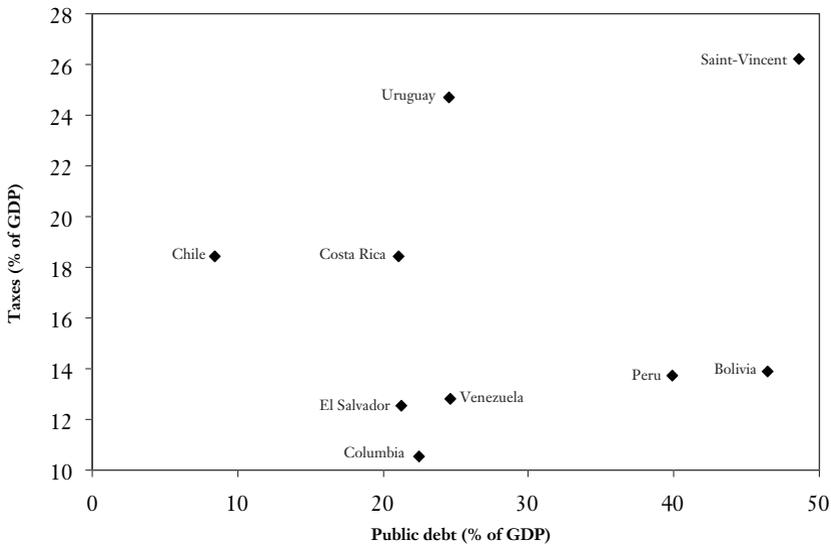
The only reasonable conclusion is that a moderate debt level is desirable, but “moderate” cannot, and should not be precisely pinned down. We simply have to rely on good judgment as to what is a desirable debt level for a country at a moment of its history. “Judgment” is the crucial word here. It means that human thinking, guided by clear principles, is a superior alternative to binding rules built around unavoidably arbitrary numbers. It requires that such judgment be made by reasonable people, free from political or other pressure.

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<sup>6</sup> See Perotti *et al.* (1998) for a discussion of sustainability as well as for useful references. They consider fiscal policy to be sustainable when there is no need for sharp adjustments. These authors conclude that, because sustainability cannot be appropriately defined and measured, attention should shift to controllability. In a sense, this is the view adopted here too, as the focus shifts to institutions which are likely to deliver a debt that remains under control, independently of its size.

<sup>7</sup> It can be objected that the three Scandinavian countries and Japan are outliers. Without these four countries, the partial correlation coefficient is positive (0.13) and significant ( $t$ -statistics = 2.27), but it is not clear why these countries should be excluded. The Scandinavian countries illustrate the main point that a low debt level may be intentionally accompanied by a large tax burden, while Japan shows that small governments can run unsustainable fiscal policies.

**Figure 3 Public Debts and the Tax Burden in 1999**  
(percentage of GDP)



Source: World Development Indicators, The World Bank.

#### 4 Institutions for Debt Sustainability

Summarising so far, two central arguments have been developed. First, fiscal policy ought to combine short-run flexibility with long-run discipline. The aim is to allow for the counter-cyclical use of fiscal policy when monetary policy alone is not enough, while ensuring that the public debt remains sustainable at all times. Second, debt sustainability cannot be defined in a precise way. In general terms, it means that the debt-to-GDP ratio is not allowed to drift upward endlessly and, where the debt is high, that it is on a declining trend. This section develops a proposal which matches these requirements.

The proposal starts from two premises. First, fiscal discipline cannot be entrusted to rigid, arbitrary rules. It requires qualified human judgment. Second, the same challenge, combining short-run flexibility with long-run discipline, has been met in the area of monetary policy by setting up adequate institutions. Accordingly, the section describes similar institutions for fiscal policy.

### *Rationale*

Long-run constraints are notoriously hard to enforce because of the time inconsistency problem: there will always exist circumstances where giving up a commitment is actually welfare improving, although as seen from the current perspective it is highly undesirable. The challenge, therefore, is to provide incentives for the authorities to abide by past commitments. The proposed solution is to rely on the delegation mechanism: a principal entrusts an agent to deliver a particular task. The question is which agent, which task, and which control.

The experience of central banks points to the answers. For both monetary and fiscal policies, the principal is the same – the people. But monetary policy is vastly simpler than fiscal policy. Monetary policy deals mainly with macroeconomic issues, inflation, growth, employment, the exchange rate. Fiscal policy includes deeply redistributive functions that cannot be delegated to a single agent: all democratic countries delegate such choices to their parliamentary institutions which, by construction, embody the diverging interests.

It is essential to realise that fiscal policy fulfils two very different tasks. The first task is structural and redistributive: the size and aims of various spending items and the structure of the tax system. Redistributive decisions cannot be delegated to an agent. The second task is macroeconomic and is largely subsumed by the budget balance.<sup>8</sup> That task does not fundamentally differ from monetary policy and, to a first order of approximation, it can be designed independently from the first one. As such it can be delegated to an agent.

The key aspect of monetary policy is that the agent, the central bank, is given a clear constitutional mandate, and is made independent. These combined attributes sharply reduce the probability that the central bank will renege on its commitments. At the same time, the agent can exercise judgment (this is one reason why monetary rules have been discarded) and today's independent central bankers deliver both long-run price stability and short-run stabilisation. This feature lies at the roots of other cases of

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<sup>8</sup> The macroeconomic effects of spending items and taxes differ, but these differences can be safely taken as second order of magnitude.

delegation, such as anti-trust or financial regulation. There is no reason why it would not work for the macroeconomic aspect of fiscal policy making as well.

### ***Fiscal Policy Committees***

In each country, responsibility for setting the budget balance would be delegated to a new institution, the Fiscal Policy Committee (FPC). Like the central banks' Monetary Policy Committees (MPC), the FPC would include a small number of qualified persons appointed for long, non-renewable terms of office. FPC members could not be removed from office unless they violate their mandates and they would not be allowed to seek or receive instructions from governments, members of parliaments or any outside person or group. The FPC would be supported by a staff that would produce its own forecasts of economic conditions and budgetary figures.

The FPC would be given the explicit mandate of ensuring *debt sustainability* over the appropriate horizon. Over the short run this would leave the FPC free to choose deficits and surpluses, as justified by its analysis of current and future conditions.

The power of the FPC would be limited to set annual deficit figures (say, in percent of planned GDP) ahead of the government budgetary cycle. Its decision would have the force of law, and impose itself on both the government and the parliament.<sup>9</sup> The FPC would have no authority regarding the size of the budget, the tax structure and the allocation of public spending. All these matters would remain as in the currently existing political process.

The budget bill, including spending and revenue projections, would require FPC approval before it becoming law. Any budget that does not comply with the FPC's balance decision would either be

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<sup>9</sup> A step in this direction has been adopted in Italy in the early 1990s. The deficit is decided by the government in the summer, and it takes the form of a law. When the rest of the budget (size, spending, taxation) is set by the government and discussed by the parliament in the fall, the budget law cannot be modified anymore. Von Hagen and Harden (1994) convincingly argue that this step has been crucial in Italy's successful efforts at stabilising and reducing its public debt. Another related development is the increased power of the Belgian High Council for Finances which can issue recommendations regarding the size of deficits at the federal and sub-federal levels, see Von Hagen *et al.* (2001).

void – and would have to be redrawn – or, alternatively, would activate an automatic procedure to bring the budget in line. As an example of the latter, spending and/or tax revenues would be adjusted pro-rata.

In the event of abrupt change in economic conditions during the period of budget execution, the FPC would mandate a change in the budget law. This could take the form of a new deficit figure, leaving again the government and the parliament with the task on adjusting spending and/or revenues. Eichengreen, Hausmann and von Hagen (1999) provide an excellent discussion of the relative merits of fixed review dates *vs.* discretionary interventions.

Finally, exceptional circumstances – unforecastable, by definition – may warrant a suspension of the debt sustainability obligation. This is what lies behind the override provision discussed in the case of monetary policy (see e.g. Roll *et al.*, 1993). Such a procedure must be exceptional: for instance, it could require a parliamentary vote with a super-majority.

### *The Debt Sustainability Mandate*

The debt sustainability mandate can be formulated as the obligation to stabilise the debt-to-GDP ratio over the long run, i.e. cycle after cycle. Countries which start with a high debt, or which face large future commitments (due to an ageing population, for example) could aim at a given reduction of the debt-to-GDP ratio over a given horizon tailored to the length of the business cycles.

Such an arrangement sets the incentives right. The authorities know *ex ante* that any budget relaxation will have to be clawed back in the not-too-distant future. As a result, they are likely to adopt a debt-increasing stance only if they think that it will be efficient, not only in the short run but inter-temporally, i.e. if today's gains outweigh tomorrow's costs. Similarly, they will take advantage from favourable conditions to garner room for manoeuvre in anticipation of future adverse shocks.

An important aspect of these principles is that they eschew any numerical target for the debt level. As noted above, there is no optimal target level for public debts. Setting quantified targets inevitably elicits criticism, to which the response is to create an artificial “holly cow” which may be difficult to change later on. In addition, as made abundantly clear by the Maastricht convergence

process, artificial targets can be easily flouted precisely because they lack a solid enough basis to be adhered to.<sup>10</sup>

### ***Democratic Accountability***

The present proposal may be seen as a technocratic encroachment on a fundamental aspect of democracy. This is not the case, for the following reasons.

#### *Macro vs. Microeconomics*

The reason why fiscal policy is everywhere under direct parliamentary control is that it powerfully redistributes income. This aspect almost entirely originates in choices regarding the size of government, public spending programmes and the structure of taxation. In contrast, budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play no part in democratic control.<sup>11</sup> Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit. Taking the deficit and the debt out of the standard democratic process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is not different from that of monetary policy. In fact, the similarity between monetary policy and setting the budget deficit can serve as a guide to the procedure of democratic accountability to be applied to a FPC.<sup>12</sup>

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<sup>10</sup> A common problem with quantified constraints, which also applies to balanced-budget laws, is that they can be escaped through creative accounting, including off-budget spending or the creation of separate government agencies exempt from the constraints, see von Hagen (1992).

<sup>11</sup> It could even be argued that the current generation is ill-suited to provide a fair treatment of future generations.

<sup>12</sup> As I was formulating the present proposal I came upon a nearly identical one by Eichengreen, Hausmann and von Hagen (1999). They go in considerably more details regarding the design and functioning of their proposed National Fiscal Councils.

### *Parliamentary Oversight*

The FPC would be accountable to a national elected body. The FPC will not be goal independent, it will be instrument-independent, since the goal will be set either in its mandate (balanced budget over completed cycles) or by the government (debt target for the length of the legislature). Accountability requires both *ex ante* and *ex post* oversight.

*Ex ante* oversight takes the form of regular testimony by the FPC president and the timely publications of the minutes of the FPC's policy setting meetings, including the votes of individual committee members, who could also be called to testify to the parliament. The FPC would be bound to publish its analysis, backed by all the technical material and data that may be used.

*Ex post*, the FPC would be held accountable of its record. In the event that the goal is not achieved, the parliament could take a number of actions: a reprimand to the committee, or to some of its members on the basis of published minutes and votes; the disappointment of the FPC, or some of its members, in case of serious failure.

## **5 Fiscal Discipline and Exchange Rate Coordination**

### *Principles*

When a number of countries decide to coordinate their exchange rate policies, they accept to go a long way towards sharing their monetary policies. The European Monetary System has become increasingly tight in this respect, to the point where full currency unification barely represented an institutional shift, not an economic one any more.<sup>13</sup> No matter how deep is the commitment – from agreeing to bilateral margins of fluctuations to joint pegging to a third currency or basket and to a monetary union – it carries important implications for fiscal policy as well.

First, with monetary policy partly or fully dedicated to the exchange rate commitment, the fiscal policy instrument assumes an increasing role in macroeconomic stabilisation.

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<sup>13</sup> This point is elaborated in Wyplosz (1997)

Second, fiscal policy indiscipline represents a direct threat for monetary policy and undermines the exchange rate commitment. Run-away debt must be ultimately monetised, which means that the exchange rate must be devalued. The expectation of such an outcome never fails to trigger speculative attacks, Argentine being a recent example, as noted above.

Third, the exchange rate is partly determined by the policy mix. While we currently do not know precisely how the mix operates, this link is not disputed. When a number of countries undertake to jointly manage their exchange rates, one country's fiscal stance becomes a common concern because it creates an externality that goes beyond the income flow spill-overs.

For these reasons, any exchange rate agreement cannot operate satisfactorily unless it is underpinned by some agreement on national fiscal policies. In Europe, this has taken the form of peer pressure, eventually formalised by the Broad Economic Policy Guidelines as a tool to enforce the Growth and Stability Pact. In federal states – a form of monetary union – local governments typically face restrictions on their budget deficits. When they don't, as is the case in Argentina, the result can be catastrophic.

At the same time, the increased reliance on fiscal policy as a counter-cyclical instrument sharpens the trade-off between short-run flexibility and long-run discipline. Each country needs to use fiscal policy reasonably actively in the short run while committing itself to deliver strict discipline in the long run.

FPCs provide the right answer. Countries that contemplate to coordinate their exchange rates need to be reassured that all members will not rock the boat by running up their debts. At the same time, each country will want to retain national control on both aspects, microeconomic and macroeconomic, of their budgets. The natural solution is to agree to set identical national-level FPCs. By providing the same incentives to deliver fiscal discipline, such an agreement would go a long way towards assuaging fears that one country's indiscipline would wreck the exchange rate agreement. At the same time, national FPCs would guarantee that fiscal policy will be available as a stabilisation instrument.

### *The Case of Latin America*

Latin America exhibits a number of unfavourable economic features.

It has been rocketed by a large number of financial crises. Several countries of the continent have achieved some of the worst inflation performances. Default on public debts have been rather frequent and widespread. Lack of macroeconomic discipline is therefore widespread. A number of countries have taken steps to remedy the situation. One of them, Chile, recently adopted a wisemen arrangement that shares many characteristics with the proposed FPC.

Equally disappointing is the low level of trade integration. Table 1 presents the openness index for those Latin American countries for which comparable data is available. By international standards, given how small their economies are, these countries are not very open. Comparing how trade splits internally (among the 11 countries reported) and externally, trade among Latin American countries is remarkably lower than among EU countries.

**Table 1 Trade Openness Index<sup>a</sup> in 2000**  
(percentage of GDP)

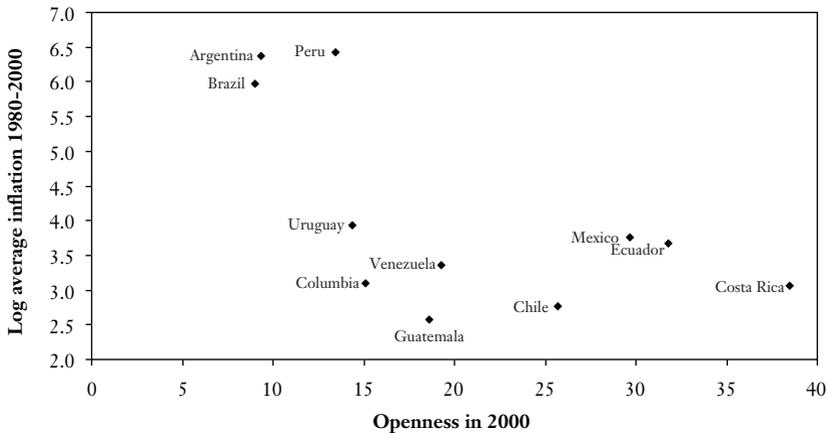
	Total	Internal
Argentina	9.0	
Brazil	9.3	
Chile	25.7	
Mexico	29.7	
Venezuela	19.3	
Colombia	15.1	
Peru	13.4	
Uruguay	14.4	
Ecuador	31.8	
Costa Rica	38.5	
Guatemala	18.6	
Latin America <sup>b</sup>	17.8	2.2
<i>European Union</i>	27.9	16.4
<i>US</i>	10.3	
<i>Japan</i>	9.0	

Notes:

<sup>a</sup> The index is the average of exports and imports as a percentage of GDP.

<sup>b</sup> Latin America as consisting of the 11 countries reported above.

Source: IMF.

**Figure 4 Trade Openness and Inflation in Latin America**

Source: IMF.

The limited extent of intra-Latin America trade is a well-known feature. One of the many reasons is economic instability. For example, Figure 4 displays for the countries shown in Table 1 the apparent association between trade openness in 2000 and inflation over the previous decade. This negative link is well-documented in empirical trade studies. One key channel is exchange rate volatility, as shown in Rose (1999).

An immediate implication is that Latin America would greatly benefit from the gains provided by deeper regional trade. To achieve progress in this direction, it would need to sharply cut exchange rate volatility, which requires enhanced macroeconomic discipline.

So far, Latin American countries have sought greater discipline through purely domestic means. Success has occurred, but occasionally and, sometimes sporadically. The recent tendency has been to seek deeper ties with the US dollar, either through a currency board or through outright dollarisation. The fiscal component of macroeconomic instability seems to remain largely neglected, though. Unless this component is firmly secured, it is to be feared that the successes achieved so far will be short-lived.

Dollar links may have serious advantages, but they fail to bring home the point that fiscal discipline is as essential to macroeconomic stability as tying the exchange rate. Chile, the first country to adopt a sound, largely depoliticised fiscal institution, has done so a decade

after stabilising its exchange rate, in fact after it had abandoned a reasonably fixed parity. The failure to ensure simultaneously monetary and fiscal discipline is characteristic of the Latin American experience and lies at the roots of repeated mishaps.

A different route is possible. Jointly undertaking to stabilise their bilateral exchange rates will not only promote regional trade and overall economic efficiency, it will also encourage the Latin American countries to focus on fiscal discipline. Concern over each other's fiscal actions – and their deep politicisation – may have played an important role in discouraging regional exchange rate cooperation. Such concern is understandable and in fact desirable. But it can be turned around from a hindrance to an incentive.

The novelty of FPCs is obviously a barrier. It shakes much conventional wisdom, especially politically. The joint adoption of identical FPC institutions would help break through such barriers. It could make the arrangement more legitimate and it would go a long way towards assuaging suspicions of poor commitment to fiscal discipline. It would open the way to exchange rate cooperation, itself a step towards monetary discipline. Peer pressure could operate in the two spheres of macroeconomic policy: through joint management of bilateral exchange rates and through formal exchanges among the national FPCs.

## 6 Conclusion

The institutions of fiscal policy discipline have been lagging behind those of monetary discipline. Yet, the challenges are almost identical. While monetary policy has moved away from rules – often adopted two decades ago – the trend now is to introduce fiscal rules. Adopting FPCs would save time and disappointments.

FPCs are the fiscal policy equivalent of MPCs. They superficially clash with the notion that fiscal policy is a purely political function, which must remain fully subject to the usual process of parliamentary oversight. This view misses the crucial distinction between the deficit, which is essentially a macroeconomic choice, and the budget structure (size, allocation of expenditures and taxes) which falls indeed in the domain where democratic oversight is essential. Budget deficits, like interest rates, are best left to non-political bodies which operate in full light and are subject to democratic accountability.

Latin America stands to be a prime beneficiary of such an approach. The politicisation of fiscal policy has been excessive and has resulted in deep and repeated economic instability. That would be a good enough reason to adopt FPCs. There is an additional reason to do it jointly: it would break the barrier of mutual suspicions and open the way, at great last, to more regional exchange rate stability, a key pre-requirement for deeper trade integration.

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# 4

## Comment on Charles Wyplosz and José María Fanelli<sup>1</sup>

*Mark Allen*

One of the first lessons that was drawn from the Mexican crisis and re-confirmed in the subsequent crises has been that an open capital account imposes severe constraints on macroeconomic policy. Countries that want to get full benefit from the access to external capital, especially emerging market developing countries, have to run macroeconomic policies that can meet the demands of international capital markets.

José María Fanelli refers in his paper to the Fund's agreeing on targets with Argentina that were very hard for Argentina to achieve. I think that is true, but this reflects the understanding of the authorities that those were the targets that the markets required, and if there is an error to be attributed to the Fund, it is that it went along with the authorities in their belief that they could implement those policies. It is not clear to me that there was a less demanding set of policies that could have achieved the objective of satisfying the international capital markets. But given the difficulties that countries have had in running policies that meet the demands of the markets, especially in the area of fiscal policy, it is understandable that Charles Wyplosz looks for better mechanisms for delivering the sort of fiscal policy the markets need.

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<sup>1</sup> The paper by José María Fanelli has been included in a separate volume, Jan Joost Teunissen and Age Akkerman (eds.), *The Crisis That Was Not Prevented: Lessons for Argentina, the IMF, and Globalisation*, FONDAD, The Hague, 2003, pp. 32-67.

Given the relative success of a technocratic approach to monetary policy in recent years, Wyplosz suggests that fiscal policy can be run along the same sort of lines. Clearly the approach is intriguing, but there are a number of problems which, at the very least, need further analysis. But, as Charles said at the end of his presentation, perhaps this is no more outrageous a proposal than the proposal to have monetary policy run by a Monetary Policy Committee seemed to be when it was initially suggested.

I want to address some of the issues I see with putting fiscal policy in the hands of a Fiscal Policy Committee. I will complement this with some discussion of the work the Fund is doing on debt sustainability, which is very relevant here, since the target of Wyplosz' proposed Fiscal Policy Committee would be ensuring debt sustainability for the country and running fiscal policy in line with that main objective.

### **Fiscal Policy is a Political Issue**

The essence of Wyplosz' proposal is that a Fiscal Policy Committee (FPC) set an obligatory fiscal deficit target aimed at achieving and maintaining debt sustainability. The first problem with the proposal is that, while the Fiscal Policy Committee can set the target for the fiscal deficit, it doesn't control the instruments that will achieve that target. The target is achieved through the sum of the taxing and spending decisions of the government as approved by parliament. This is in contrast with the position of a monetary policy committee, which actually wields the instruments that are applied to meet its targets. In order to deal with this problem, Wyplosz proposes that the Fiscal Policy Committee be backed up by legal restraints on what the government and the legislature can do. The government would be compelled to deliver a budget in which it can spend what it likes and can tax as much as it wants, as long as it comes up with the deficit that was proposed by the Fiscal Policy Committee.

However, these decisions to tax and to spend are the most hotly contested areas of politics – they are what politics is all about. It is very hard to see how the struggles on the trade-offs between spending and taxing decisions will not rebound on the Fiscal Policy Committee itself. When things get tough, the pressures on a Monetary Policy Committee can be very severe, as they are in Poland

at the moment. I would see the pressure on a Fiscal Policy Committee being even more severe when the economic conditions were difficult or when the political struggle was intense.

Wyplosz' proposal also assumes that an effective legislative straitjacket can be devised to constrain this mechanism. We have seen fiscal responsibility legislation in a number of countries. Wyplosz mentioned a few examples like the Stability and Growth Pact in Europe, some of the longer-term fiscal legislation in the United Kingdom and the United States. There is also a lot of recent experience in Latin America with fiscal responsibility legislation which is actually not very encouraging. The problem is obviously that, when you pass a law, you can unpass the same law very easily – the time-inconsistency problem. To remedy this, you can make it an organic law, as Ecuador is trying to do at the moment, which will be much more difficult to overturn. But these legislative straitjackets are very hard to implement. It is possible that as popular acceptance of the proposal increased, the legitimacy of such constraints would become stronger, but I do see considerable difficulties for this approach in Latin America, given the current problems with fiscal responsibility legislation.

More generally, I wonder whether these proposals are based on a 'technocratic fallacy'. Just leave economic policy to the economists and let the politicians squabble about something else. While this has become conventional wisdom for monetary policy, I am not convinced that in the longer run it will remain so. More fundamentally, the problem of governance in large parts of the world is to produce a mature political system that internalises the need to make trade-offs and social choices within a given envelope. But I doubt that establishing a Fiscal Policy Committee will help in producing a mature political system in which there is a general understanding of the need to make societal choices within a resource envelope. Discussions on the stance of fiscal policy are political decisions, not purely technocratic ones. But perhaps the Wyplosz proposal is part of the spadework for creating such mature political systems.

## **Debt Sustainability and Fiscal Policy**

This brings me to the work we have been doing in the Fund on

sustainability. We have realised the importance of getting a better handle on this concept. The Fund should not lend to a country whose debt is unsustainable, without action being taken to make it sustainable. The discussion of sovereign bankruptcy presumes that a judgment can be made as to what debt structure is sustainable and what unsustainable. A paper on this was discussed recently by the Executive Board and is available on the web.<sup>2</sup> In this paper we look at two aspects of sustainability: the external sustainability of a country's debt, and fiscal sustainability. I shall concentrate on the latter since it fits well with Wyplosz' chapter.

A government's debt is sustainable if the debt dynamics are expected to remain under control, without the need for a major adjustment in policies at some point in the future. The chances of the debt dynamics staying under control are the result of factors both under the control of the authorities and any Fiscal Policy Committee and those beyond their control. They will depend on the stance of fiscal policy, growth and interest rate expectations, shocks hitting the economy, developments in world and partner country goods and financial markets, etc. There is uncertainty about many of these factors. Thus a country's debt and fiscal policy may be sustainable in some states of the world and not in others. At any time one could in principle make the judgment that there is such-and-such a probability of the debt being sustainable. In the Fund, we are planning to be much more explicit about the elements that enter into a judgment on sustainability and the chances of worse outcomes than the baseline projection. But ultimately all we can do at the technical, staff level is to put the elements forward on which the difficult – political – decisions have to be made.

The Fiscal Policy Committee will also have to make these judgments – but the scope for disagreement is going to be large. Not only on the probabilities of distant events, but also on how risky a policy to run, or how fast to converge on a given target. Should the country run a fiscal policy where the chance of a crisis is 1 in 5, or should policy be directed to reducing the chance of a crisis to 1 in 20 or 1 in 100? These are political, not technical, decisions.

One possibility might be to put these elements into the contract of the Fiscal Policy Committee, in the same way that the inflation target

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<sup>2</sup> International Monetary Fund, *Assessing Sustainability*, May 29, 2002. <http://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf>

is put into the contract of the governor of the Bank of New Zealand or the Monetary Policy Committee of the Bank of England. But it is quite different to set as a target 'keep inflation below 2 percent', which is clearly defined and manageable than a target in the form, 'keep the risk of the debt becoming unsustainable to 1 in 5'. The next year, if there is a crisis, the Committee could argue that it did a fine job, but this one was just the one year in five. It is hard to specify without a lot more further thought what the precise targets of the Fiscal Policy Committee would be.

There is some discussion of what is a safe debt stock in José María Fanelli's paper. At the Fund we have been looking to see whether there are key thresholds for determining sustainable debt, for example, as used in the HIPC Initiative. And, quite frankly, we have not got very far. We did discover that the probability of a default in an emerging market rose quite sharply when the fiscal debt to GDP ratio went above 40 percent. Below 40 percent, *grosso modo*, the chance of a crisis in the following year is 2 or 3 percent; above 40 percent debt ratio, the chance of a crisis rises to about 20 percent.

Even so, it is not clear what the operational conclusion is. If the Fund were to be very strict with a country whose debt ratio went beyond 40 percent, refusing to lend unless it restructured, in four out of five cases, the country would actually have been sustainable at that level and the restructuring would have been unnecessary. So, these debt sustainability concepts are quite hard to apply to fiscal policy.

The one clear message I got out of the papers by Fanelli and Wyplosz is the importance of low debt ratios well below 40 percent. Only such low ratios give the country room for counter-cyclical fiscal policy, as well as a margin to cope with shocks.

# 5

## Floor Discussion of “Latin America: How to Achieve Stability and Growth?”

### The Studart Paper

György Szapáry, deputy governor of Hungary’s Central Bank, did not share governor Nout Wellink’s optimism in his opening remarks that we will hopefully learn from experience and have both fewer and shorter crises. “This reminds me,” Szapáry said, “of what Bernard Shaw once said, that experience is that wonderful thing that allows us to recognise a mistake when we make it again. All the crises seem to have the same causes.”

Szapáry stressed that supervision could not play any positive role once a crisis emerged. “Supervision concentrates on avoiding banking crises and allowing banks to function well in a normal situation. In a crisis, supervision cannot really help, because banks will not be able to function well. Banks are as good as their clients are, while clients are as good as the macroeconomic situation is.”

Turning to what central banks can do to prevent crises from happening, Szapáry pointed to three lines of action. “First, it is important to control open positions. Many banks get into trouble when they have excessive open positions. Second, one has to find ways of controlling, or at least monitoring, borrowing by clients from abroad. In fact, you are looking at the open positions of the clients, for which of course you do not have a specific institution set up to control, but you can monitor them and try to impress banks by moral suasion when you see that there is over-borrowing by the companies.

Third, one increasingly notices that the internal audits of the banks are often not done correctly, but on top of it, the audit companies are not always doing a good job either. We have seen that in the case of Enron, but we also see it in the case of banks. Sometimes banks are hiding problems and the international audit companies do not bring that to the fore. Perhaps a supervisory agency of audit companies could tackle this increasing problem.”

Ariel Buira, a former deputy governor of the Mexican Central Bank, confirmed Szapáry’s suspicion that banks may be hiding problems. In the early 1990s, Buira had experienced that Mexican bankers did not reveal non-performing loans in the balance sheets. “They just renewed the credit so that it appeared as current and the indicators of performance remained fine. However, this was only possible with a very poor legal and supervisory framework. If you lent to a company that went broke, it was a very long-winded process to recover your loan. If somebody stopped paying a mortgage, it was virtually impossible to recover the loan. But all these issues of the legal framework have been solved. Supervision has been restrained and greatly improved.”

With regard to the issue of capital account liberalisation, Buira recalled Mexico’s experience in the 1990s. “Mexico always had a fairly open capital account, but when it joined the OECD there was a strong pressure to lift the one or two remaining restrictions. The main one was allowing foreign investors to buy Treasury bills. This made a huge difference in the size of the problem that came later. If the foreign investors had not been allowed to hold Treasury bills, you would not have had the huge build-up in dollar-denominated debt which later became such a crucial element in the emergence of the 1994-95 crisis.”

Buira shared Szapáry’s scepticism about the role of supervision in a crisis situation. “Once you have a macroeconomic crisis, a banking crisis is inescapable and inevitable. It does not matter how well capitalised and regulated you are, if mortgages are a fourth of your portfolio, it takes all of the banks capital. If the firms you have lent to cannot pay you, again you are wiped out as a bank.”

Aert Houben, of the Dutch Central Bank, endorsed Buira’s last view pointing to the case of Argentina. “In Argentina you had a very solid banking system, lots of capital, foreign owned banks with state-of-the-art risk management techniques and so on. Clearly it was the macroeconomic regime and the macroeconomic environment that

were driving the crisis.”

Houben suggested including another macroeconomic variable in the analysis, the domestic savings ratio. “A low domestic savings rate is a dominant macroeconomic variable in many Latin American countries. That implies that they are dependent on international financial inflows, and therefore are vulnerable to shocks in the international financial sentiment. At the same time, domestic financial markets are not very deep, because they are not generating and intermediating these savings. A complication is, that domestic savings are not easy to steer; it is very difficult to generate more domestic savings. Maybe fiscal policy can play a role here, in pension policies for example, to try and deepen domestic savings and domestic financial markets.”

Roy Culpeper, of the Canadian North-South Institute, noticed a clear difference of opinion about the role of foreign banks in developing countries. “First, I take it from Rogério’s analysis that the presence of foreign owned banks could lead to destabilising competition rather than stabilising competition. This is at odds with what Mr. Wellink was saying in his introductory remarks, that competition from foreign owned banks was much to be encouraged. And Yung Chul Park is making the same point, that the increasing encroachment of foreign owned banks in East Asian economies has played a rather destabilising role. In Canada we always have been rather strict with foreign owned banks. They have never been given much leeway, for precisely the reason that it was thought, and is still thought, that foreign owned banks would undermine the stability of the domestic financial system. There is some real debating material here. It reminds me of Keynes’ dictum that ‘let’s engage in trade and commerce, but ultimately let finance be domestic’.”

Culpeper thought that Rogério Studart’s reference to unemployment as an indicator of economic performance was an interesting and innovating broadening of traditional indicators. “This is something new, because – as Jürgen Stark commented – financial and price stability are the key objectives. I found it very interesting that Rogério looks at the correspondence between unemployment and non-performance in the banking portfolio. This is encouraging, because the financial sector should worry about the real sector and how it is performing.”

Frans van Loon, from the banking and insurance company ING, stressed that the discussion of the financial system needs broadening

beyond that of the banks. “It should include savings in whatever form and domestic capital formation in its broadest definition. Specifically, it should include all contractual savings as an increasing important element for domestic stability: contractual savings from insurance, from pensions systems, from social security, the run-over between public and private savings. In this context, I was struck by Jürgen Stark’s emphasis on the two points of sequencing and the need to strengthen domestic institutions. Jürgen Stark mentioned as domestic institutions the central bank, the judiciary, the courts and all that. Again, one should add contractual savings mechanisms and pension insurance systems.”

Van Loon pointed to the strong interaction in the world of banking between regulation and business, and the impact this has had on banking in Latin America. “In the 1990s, all over the financial world there has been a trend to develop new systems of risk management. They have led to drastic changes in the way we look at risk taking and our daily practice of approving credits. Its influence goes beyond the domestic arrangements in the countries of the advanced banks. The strong foreign dominance of banking in Latin America was also steered from abroad, from Amsterdam, from London, from Frankfurt, based on the new, much more technocratic and very high-quality risk management systems that we have these days. That is somewhat risky, I would dare to say, and may act as a source of instability in financial systems in Latin America.”

Another important new element of the 1990s that should be included in the analysis, suggested Van Loon, is the increasing importance of the so-called stockholder value system. “It is a short-term evaluation, where you are looking at the price of your stock, and the effects of that on stockholder behaviour. Both together are leading to a tendency of risk aversion, which has influenced the willingness to take on credit. This may be another source of instability.”

Amar Bhattacharya, of the World Bank, stressed that if one wanted to draw lessons from the past crises, one should not forget about the role that weaknesses in the international financial system have played in the build-up of vulnerabilities in Latin America. But since Studart’s paper focuses on the domestic aspects, Bhattacharya left that important international dimension aside and dwelled upon the four aspects of domestic financial systems discussed by Studart. “The first is the pace and sequencing of capital and financial

liberalisation. The second is the soundness and consistency of macro policy, in particular that of fiscal policy with exchange rate regimes in an open capital account setting. The third is weaknesses in the financial system, and the fourth is weaknesses in the corporate sector including corporate governance and all the institutional fundamentals mentioned by Jürgen. What I found interesting about the paper is that it shows that the weaknesses in the financial system led to a build-up of vulnerability *before* the Tequila crisis, especially in Mexico and in Brazil, but that it did not do so *after* the Tequila crisis. Indeed, the financial system in Latin America does not contribute to the build-up of vulnerability, neither by a credit boom nor by mismatches in the financial system, whether it be in unhedged open position or in maturity mismatches. That is in striking contrast to what happened in East Asia. So, as other people have argued, it was macroeconomic weaknesses impacting on the banking sector, rather than the other way around. That is a very important point that comes through in the paper and is worth stressing.”

Stephany Griffith-Jones, of the Institute of Development Studies, stressed the importance of simultaneously improving the *domestic* and the *international* financial system, and she observed that the progress has been very asymmetric. “There has been important progress domestically, but there has not been sufficient progress internationally. Because things are so integrated, as for instance Frans van Loon just said, this asymmetric progress will continue to be problematic and will make countries vulnerable to crises. This is not to say that the domestic system is unimportant, it is important, but it is only one of the conditions.”

Jürgen Stark, deputy governor of the German Central Bank, said that although much progress has been made in crisis prevention, this does not hold true for crisis resolution. “We are far away from consensus on private sector involvement in the resolution of financial crises, as well as on access to IMF funds. I agree that we need symmetric progress both at the domestic and international level. At the national level, strong institutions should be in place. The international institutions only exist to deal with deficiencies at the national level. Therefore, there should be a focus on domestic reforms.”

Griffith-Jones said that Jürgen Stark had made a very important point in his comment on Wyplosz’ paper when he recognised that capital account liberalisation had been carried out too quickly. She

wondered: “What do we do about it, now that we know we have liberalised capital accounts too quickly? Can we go back? Or do we just make recommendations for the few countries that have not yet liberalised?”

Following up on these questions, Charles Wyplosz, of the Graduate Institute of International Studies in Geneva, said that, like Griffith-Jones, he was struck by Stark’s recognition that official views have changed on the point of capital account liberalisation. “This is something which has been discussed in previous Fondad conferences, where some of us were complaining about the push towards liberalisation and we always identified the villains in this push as the Americans, the British and the Germans. This is what seems to be transparent from these G-7 meetings. It is important to realise that of the views that are strongly held today, some will be thrown away tomorrow as wrong. It always baffles me that policymakers give the impression that they have no doubt that what they say today is right. I want to make it very clear. For example, today Stephany asked ‘should we go back now on capital liberalisation?’ And we are talking in this conference about South-East Europe while right now the EU is putting tremendous pressure on the accessing countries to remove capital restrictions. So this whole process of capital account liberalisation is not going back. However, in my opinion, EU authorities should recommend capital account restrictions for the accession countries.”

Stark replied, “Germany has always emphasised the importance of appropriate sequencing of capital account liberalisation. Practically speaking, for the EU accession countries this means that long transition periods should be implemented.”

Griffith-Jones agreed with Rogério Studart that there is a trade-off between financial stability and growth, leading to the question of how tight regulation should be. She added another question: “Should there be more counter-cyclicality in regulation given that financial institutions, and banks in particular, are so pro-cyclical? They may become even more pro-cyclical, because they are using these very sensitive risk models which tend to vary strongly with the cycle, and which the new Basel Capital Accord wants to give a prominent role in determining the capital adequacy ratio.”

Charles Wyplosz was sceptical about the usefulness of capital ratios. “It is not sufficiently realised that all capital ratios – no matter how good they are – are based on assets, which go wrong during

crises or shake-ups. You can have the best asset ratios possible, but when you need them they will be gone. It is sort of the opposite of what György Szapáry said; you do not need to have regulation in normal times – you need regulation for the worst cases. Therefore, it is almost a hopeless strategy to try to have the good capital ratios. The whole Basel Agreement misses this view completely. If you have an Argentine bank or are holding Argentine assets, the day Argentina is shaking, all of these asset ratios are gone. What you need is Argentine banks holding Dutch or Korean assets and Korean banks holding the others. That is the way to diversify. The first thing you teach students is to diversify, but it is not done and it is not at all creeping into discussions on regulation.”

Replying to some of the questions, Rogério Studart said he did not think that the savings rate in Latin America was the problem. “The savings rates in Latin America were not that low, as some speakers suggested. Not the savings rate itself, but rather the allocation of savings to the most productive investment is the problem.”

Studart agreed that after the Tequila crisis banking problems did not lead to macroeconomic problems, but rather the other way around. But he warned, “we are getting into a situation of a very stable financial or banking sector, but we are also getting credit stagnation, and that is a problem. We need a system that is both stable and able to provide the credit required for economic development.”

With regard to the development of the financial sector in developing countries, Studart believed that progress still has to be made in terms of institutions and institution-building. “If you look at institutions as rules of the games, there have been a lot of improvements. But if you look at institutions as physical institutions, much needs still to be done. Financial institutions and financial markets are required for the system to work well, and that kind of institution-building has not yet progressed enough in Latin America because of a lack of long-term policies. Institution-building is a long-term process, which requires time and stability, especially price stability and macroeconomic stability in the way we thought about it back in the sixties.”

## **The Wyplosz Paper**

José Antonio Ocampo, executive secretary of ECLAC, agreed with

the two basic ideas in Charles Wyplosz' paper, that there should be short-run fiscal flexibility with long-run fiscal discipline and that good judgement is better than rules. But he had "significant differences" in the diagnosis and in the recommendation. "In the diagnosis, a problem arises, for instance, by looking at Charles' figure on the debt ratios in Latin America. It is not really fiscal deficits but rather currency crises that drive the debt-to-GDP ratios in Latin America. Latin America had a history of fiscal indiscipline, but that is no longer true. If you look at time series of fiscal deficits for the 1990s, you would see that the deficits have actually been kept at very low levels, except in a few countries. Figure 2 in shows that the debt-to-GDP ratio in Latin America exploded once the debt crisis broke, and not before the crisis broke. And the same thing is true of Argentina. Their debt-to-GDP ratio increased sharply once the crisis broke, not before the crisis broke. So the problem with debt sustainability levels in Latin America is no different from how to avoid a currency crisis. The debt dynamics of Latin America are only secondarily determined by fiscal irresponsibility. Public debt dynamics are not determined by too loose fiscal policy, but rather by exogenous shocks, such as currency crises."

Ocampo observed that the reform policies in Latin America have increased the pro-cyclical bias of both monetary and fiscal policy. "We had sharper business cycles in large part because the reforms have enhanced the pro-cyclical bias of macroeconomic policies. I would be a bit careful about saying that the monetary institutions have been so excellent. If you go around Latin America, you will hear that autonomous central banks have certainly increased long-run flexibility, but probably have also increased the pro-cyclical bias of monetary policies."

Ocampo doubted whether a new institution like the proposed Fiscal Committee was really needed. "We have already achieved a lot more fiscal discipline in Latin America through existing institutions: first, through strong ministries of finance and second, through independent central banks. I was a finance minister in Colombia; I talked with the independent central bank about fiscal policy all the time. In our countries, independent central banks necessarily get all the time involved in fiscal policy and are a countervailing power in the fiscal area. Third, we have a lot of international pressure. Unfortunately, that international pressure is a bit pro-cyclical, including the pressure of the IMF. There is not enough pressure

during booms, and there is too much pressure during crises. Maybe changing the international pressure will actually help to reduce the pro-cyclicality. There may be one institution that is missing in the institutions, which is a strong advisory board to Congress. Think for instance of the role in the US of the Congress Committee on the budget, that is a very important institution that we are missing. The discussion in our congresses is very poor. So we may be missing some institutions, but a fiscal committee is probably not the sort of institution that we are missing.”

Ocampo emphasised the importance of democratic discussions about the budget. “I would say that the increasing democratic discussion is better rather than worse. Technocracy is very good when it is part of a democratic discussion process; it is not good when it is free from democratic discussion. Actually one of the good things we have in Latin America today is that we have many technocrats in the public discussion presenting their views on what a correct fiscal policy is. That discussion should be a part of the process.”

Yung Chul Park, of Korea University, wondered whether the proposed Fiscal Policy Committee would be involved in decisions on military spending. “Who is going to decide how much military spending there will be and on what hardware? (Not this Fiscal Policy Committee, oh I see, they will only deal with macroeconomics, right.) But there is the problem of income distribution and other targets related to expenditure, which has macroeconomic implications, and so does macroeconomic fiscal policy has microeconomic implications. Also, the politicians will come in and then they may find out that some of these committee members took bribes... So where do we stand on this?”

Park also had a question for Mark Allen, of the IMF. “I am increasingly disturbed by the IMF asking countries to do certain things, because that is what the markets ask for. What is the market, what are market participants? They are my neighbours, they are my brokers and they are my friends doing all kinds of research at the Deutsche Bank, or Citibank and all these banks. You don’t think that the IMF has any influence on these market participants’ behaviour? If it does not, well, you are in trouble!”

Zdeněk Drábek, of the WTO, fully agreed with Yung Chul Park’s last remark, “because often the conclusion of an IMF programme is a precondition for any orderly lending by the private sector”. He also agreed with Park’s remark about the link between macro and micro

issues. “First of all it is not clear to me how it would be defined, but even if it is, we run into the kind of problems that Yung Chul has just mentioned. Take the example of the Czech Republic, which as of this year is trying to buy fighter planes amounting to 80 billion Czech Crowns. It is bigger than probably the total budget of federal and local authorities together. So obviously they have to go through the parliament. The parliament will be deciding on the purchase of fighter planes, and that is going to generate a debt of enormous proportions for the country. Now I just can’t see how this would fit into the scheme of the fiscal policy committee.”

Drábek also wondered what the link would be between the Fiscal Policy Committee and the Monetary Policy Committee. “Which of the two decides that their tool should be used as a counter-cyclical instrument, the Monetary or the Fiscal Committee? What incentives would you give to each one of them to operate? How do you ensure that they work consistently? That is another type of question that you will need to answer. It seems to me that it is not only a problem of not having control over fiscal instruments, that Mark Allen has mentioned, but also a problem of how to make these institutions to really operate. I am afraid you will run into very difficult issues.”

Brian Kahn, of the Central Bank of South Africa, endorsed Drábek’s question about the relationship between the Fiscal Policy Committee (FPC) and the Monetary Policy Committee (MPC). To explain the difficulties that are likely to arise, he mentioned South Africa’s recent experience with a sudden change in the exchange rate. “I want to emphasise the issue of exchange rate shocks for emerging markets. Inflation targeting may work well in many countries, but the big test is whether it is sustainable in the presence of exchange rate shocks – which have an impact on the debt-to-GDP ratio. In South Africa in 2001, we had a shock of 40 percent depreciation of the rand against the dollar in a period of three months. You can imagine what that has done to our inflation target. This raises the issue of debt sustainability once you take the real exchange rate as part of the sustainability criteria. That leads to the problem of how do you relate to the two institutions together? What is the relation between the FPC and the MPC? These institutions work at different time horizons.”

With regard to military spending, Kahn mentioned that South Africa recently had a similar situation as the Czechs. “There was an arms deal over 20 years, a contractual arrangement of around

25 billion dollars. It was very much a political decision that went through parliament. Obviously, it is denominated in dollars, which means that an exchange rate change would have major implications for the future financing of this transaction. How would the FPC deal with such a situation?”

Wouter Raab, of the Dutch Ministry of Finance, agreed on the importance that Wyplosz attaches to sustainable debt, but disagreed with the need for fiscal discretion. “Fiscal discretion leads to a debt bias in the long run since it is not applied symmetrically during the business cycle. Counter-cyclical policy is only applied in a downturn, not in an upturn. A more pragmatic reason why I am against fiscal discretion is that it is likely to have a pro-cyclical effect. For instance, it is important to realise that a recession usually only lasts some three quarters. We often need one or two quarters to identify a recession, then one quarter to decide on appropriate policy, and at least one quarter to implement this policy. This is why the average stimulus comes into force when the recession is already over. These lags make fiscal policy pro-cyclical, as the US witnessed in 2001. The most we can ask of fiscal policy is to let the automatic stabilisers do their work. The degree of stabilisation these offer depends on the economic structure of a country. I would expect that automatic stabilisers work a bit less in emerging markets than in the EU. Nonetheless, we should look for mechanisms to improve the workings of the automatic stabilisers instead of relying on fiscal discretion.”

Raab missed the need for market flexibility in the economy in Wyplosz’ paper. “One of the most efficient ways of dealing with cyclical shocks is increasing the flexibility of markets to adapt to changing circumstances. In Argentina, people were applauding Argentina’s achievements, but I was struck by the inability to address the unemployment situation. Every macroeconomic system with an exchange rate that is delivering over 10 percent of unemployment with no perspectives of getting it down, is bound to come under serious constraints and pressure when exogenous shocks occur – because of the level of unemployment and constraint on the monetary policy authorities to raise interest rates etc. The credibility of a system that is not able to deliver full employment is at stake. It is more efficient, particularly in Europe, to try and make markets more flexible than work in the direction of fiscal discretion.”

Raab wondered whether a panel of independent experts of the proposed FPC would be strong enough to apply strict symmetrical

fiscal policy around the cycle. “In Wyplosz’ proposal, the FPC is fully transparent and democratically accountable to parliament. That could lead to a situation where the parliament does not agree with the proposition. If it can sack these people, how independent are they really? The pressure on them will be enormous. For example, how would you apply fiscal constraint in an upturn? Taxes cannot be raised in an upturn because that would raise inflationary pressure. Reducing infrastructural expenditure would just increase the bottlenecks, which are already in place in a situation of overheating. Lowering social benefits, for instance health care, just attacks the social cohesion. At a time when other incomes go up by 5 percent or more, this is a very difficult thing to do and is bound to stir a ferocious political debate. I wonder what the support for such an independent panel could be. If politicians are not keen on taking the responsibility for those actions, who else in society will? So I think you can not do without political leadership here.”

Marek Dabrowski, a former deputy minister of Finance of Poland, saw a contradiction in Wyplosz’ proposal. “On the one hand, you want to impose some rules on fiscal policy, which I am very sympathetic of. On the other hand, you want to leave quite substantial room for discretion, for counter-cyclical fiscal policy. To solve this contradiction, you look for a magic solution that has some characteristics of the technocratic illusion, that you can find a group of experts who will be able to solve this problem in an optimal way. In the real world, however, you have either a good track record in macroeconomic, monetary and fiscal policy, or not. If you have a good track record, this gives you a bit more room for flexibility and discretion. But then, if you have a good track record, you do not need an additional straitjacket.

In the case of developing and transition economies, discretion is not a good proposal. It is contradictory with a problem Charles addresses in his paper: the problem of expectations. If a country does not have a very good record and resorts to discretionary policy – even if it has certain rules for the discretionary policy – markets do not have to believe in the soundness of such discretion. And if the markets do not believe the soundness of discretion, they will penalise the country in a painful way. In my view, this is what happened in many emerging market crises.”

A final criticism of Dabrowski on the Wyplosz proposal was that there is a problem of time lags and time horizon. “In the case of

monetary policy, the longest time lags between monetary changes, interest rates, and inflation effects are 18 to 24 months, and in most countries lags are shorter. But today's fiscal decisions will have an impact on financial sustainability in 10 or 20 years. What should be the time horizon of a FPC? Wyplosz talks about the possibility of revoking, changing the committee, if it does not follow rules. That means it is no longer independent. I cannot imagine that a parliament will stop the term of the committee because it is not tough enough. Probably it will only stop it because it is too tough."

Barbara Stallings recalled that the FPC is not a new idea since it had been proposed a number of years ago by Ricardo Hausmann of the Inter-American Development Bank and was subsequently rejected by the member states. "But if we look at Charles' paper in the spirit, and not in the letter, it offers much to recommend. I think it is very useful to clearly separate at the conceptual level the deficit or surplus issue from the level of expenditure and the taxation, to say nothing of the content of expenditures and taxation. In Latin America there are vast differences, no matter what the deficit or surplus is. There are countries that are raising and spending 30 to 35 percent of GDP and there are countries that are raising and spending less than 10 percent of GDP. This makes a tremendous difference. Not separating out the issue of deficit or surplus from the level of expenditure leads us to gloss over some very important issues in the fiscal area. It is also the case that external actors, whether it is the IMF or the bond markets, are basically interested in the deficit issues. So it gives you more flexibility if you can separate those out and keep those people out of the issues of levels of expenditure and taxes and the contents of expenditure and taxes.

My conclusion is, that we should take Charles' proposal in spirit as opposed to letter. We should concentrate on an advisory board as opposed to some board that could in principle make decisions. It is important to place this advisory board in Congress, to educate the Congress about these kinds of issues. The Congressional Budget Office in the US is a good example. I would second that as a more flexible and realistic version of Charles' proposal."

In his reply, Charles Wyplosz first noted that many critics did not take to heart the importance of separating decisions on the deficit from decisions on the level and structure of spending and taxation. "Take for example the weapon acquisition issue. If the democratically-elected authorities insist that they have to spend

resources on weaponry, this is their absolute right but it is not a technocratic question to ask how this item will be financed. The proper framework has to be one that requires the authorities to answer that question at the same time as the proposal is put to the parliament. One solution – not necessarily the best – may be to raise the debt ceiling, which would then be given to the FPC as a modified target. It is hard to believe that explicitly recognising the debt implication is less desirable than keeping the financing implicit as seems to be the case in the examples described by various speakers. The critics miss the simple point that for such purchases not to endanger debt sustainability, we need accounting procedures that extend over the long run, FPC or no FPC. FPC-type arrangements impose a proper accounting, and that cannot be construed as a weakness of the proposal.”

Wyplosz recognised that the question of coordination between the FPC and the MPC is very important. “As noted by José Antonio Ocampo, the debt is largely endogenous to the exchange rate, which lies partly in the hands of the central bank. But let’s separate the debate into two questions. The first one concerns the danger of a vicious circle that goes from market fears of debt non-sustainability to currency crashes and to effective debt non-sustainability. This is by now a classic and well understood case of self-fulfilling crisis, driven by expectations. If the markets believe that a debt default is looming, there is little that the central bank can do about it. There is much debate on the merits of an interest rate defense, if only because sharply raising the interest rate also threatens debt sustainability. There is no miracle solution, but any one will have to work on market expectations. The essential merit of an independent and powerful FPC is precisely to anchor expectations. An untested FPC may not always be able to break market concerns, but it is now increasingly recognised that adequate institutions represent our best hope to deal with market jitters. Until a better institutional proposal is put forward, the FPC idea is the one that comes closest to providing protection against this kind of crisis that has repeatedly played havoc throughout Latin America.

The second aspect is the risk that the MPC and the FPC will attempt to act as free-riders on each other. Both must be independent and democratically accountable. Being shielded from electoral pressure, they are unlikely to be major offenders, and both are likely to be exceedingly prudent. This confirms the remark by José Antonio

Ocampo that independent central banks are found to act in a pro-cyclical way. I admit that this is a structural weakness of such institutions, one that will be erased by proper political oversight within the democratic accountability framework. Until that happens, there might well be some degree of pro-cyclicality. Bad as it may be, it is better than runaway inflation and debts, which is what we have seen over the last decades.”

Wyplosz finally addressed the “technocratic illusion” problem mentioned by Marek Dabrowski and others. He noted first that the only item removed from the realm of politics is the deficit, not the other more sensitive aspects of the budget. He then observed that, like price stability, debt sustainability requires some limit on the deficit process. “A rule does just that, and no one objects to it. A FPC is only an intelligent, i.e. feed-back rule. So the problem is the feed-back, the fact that someone can realise that blindly applying a rule can be counter-productive. Yet, this has become acceptable for monetary policy, so the real problem is to go one step further in the same direction. What may seem unrealistic today may become reality tomorrow. Just remember when we started to talk about monetary union at a similar table 15 years ago, everybody was laughing, saying it is politically unacceptable. I remember having discussed the idea of independent central banks with the authorities of a number of countries, and people were laughing at me. They said, ‘you can’t start thinking about that, it is politically unacceptable’. About capital account liberalisation, Jürgen Stark said, ‘We changed our mind’. I predict you will change your mind faster than you think.”