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Introduction

The story of interwar Latin American finance is one of high inflation, exchange rate crisis, and debt default. Today, once again, the Latin American financial scene attracts attention and demands analysis. The decade of the 1970s brought a huge increase in Latin American borrowing from the world capital market. Greater financial integration opened new opportunities—and created new risks—for both borrowers and lenders. Concurrently, the growing external linkages have imposed tighter constraints on domestic macroeconomic policies.

The essays brought together in this volume share a common objective: To bring a unifying methodological approach to the analysis of financial problems in developing, open economies. While the primary focus is on contemporary Latin America, the methods employed and the lessons learned are of wider applicability. The papers address the financial integration issue from three different perspectives. In some cases, a country study is the vehicle for an econometric investigation of a particular external linkage. In other cases, an individual country's experience suggests an economic model in which the stylized facts may be analyzed and developed. A third direction is unabashedly theoretical and formulates more general principles which are broadly applicable rather than country-specific.

Two examples will highlight the issues. In the late 1970s, Argentina embarked on a long-term program of financial stabilization. The key elements were a preannounced exchange rate path, complete freedom of capital movements, and a substantial reduction in trade barriers. Argentina's rush to financial integration produced severe real effects, most importantly a sharp and persistent overvaluation of the currency and extraordinarily high real interest rates reaching 100 percent and over. The cause of the high real interest rates, at least, is now clear, for a

number of large devaluations—deviations from the preannounced policy—have turned out to validate the expectations that market interest rates reflect. In the area of external debt, Brazil is surely the biggest (if not the leading) problem case. In June 1981 its external indebtedness to banks stood at roughly \$46 billion. External borrowing has been large, in good measure financing current public and private consumption rather than productive investment. But how should external borrowing be analyzed in an economic framework? In particular, is Brazil's debt too large? Is it worth making the extreme growth sacrifice Brazil has chosen in the 1981 recession to improve the external balance?

These are only examples of the issues this book addresses. But they do convey the importance of the issues and the need for a serious, coherent investigation of the linkages between the world capital market and the domestic policies of industrializing economies.

The volume opens with two general papers which provide a backdrop for the study of Latin America's links to the world capital market. Carlos Díaz Alejandro approaches the question from a historical perspective, exploring the Latin American currency experience of the 1930s. What lessons are to be learned from that period, when Latin America imported the effects of the Great Depression and sought an internal and often successful path to recovery? Díaz Alejandro concludes, "After the initial external blows, the active countries steadily gained in both ability and will to maintain growth regardless of foreign conditions." Study of the 1930s is revealing, for it illustrates the costs of close integration when the world economy malfunctions. A further lesson is that by getting out of step with the world economy, countries may, at times, do better. Michael Mussa's paper addresses the same set of issues from a purely theoretical standpoint. How much integration should a country seek? The answer, to a first approximation, is as much as possible. As Mussa notes, however, the answer is less simple when there is a trade-off between domestic objectives and first-best resource allocation. Here, the limited case for insulating home markets is investigated, albeit with little sympathy.

The papers by Stanley Fischer and by Guillermo Ortiz focus on three closely related topics: The costs and consequences of different exchange rate regimes, the choice of a monetary standard, and the viability of country-specific money when the economy is open. Fischer makes a theoretical case for exchange rate flexibility and a national money. When public good provision is financed by distorting taxes on labor and commodities, the aggregate deadweight burden of taxation is higher than it would be if a tax on money—the inflation tax—were employed as well. A flexible rate regime is desirable, Fischer concludes, because it allows the government to choose the optimal steady state level of seigniorage from money creation. Ortiz offers a chronicle of Mexico's monetary experience from the standpoint of currency substitution. A central message of

his is that a close link exists between the public's willingness to use government-issued money and the public's beliefs concerning future government financial policies. Ortiz explores in detail the stability over time of the currency composition of Mexican money holdings, which consist of peso-denominated deposits and currency and U.S.-dollar-denominated deposits. He finds that the Mex-dollar component of domestic money holdings rises significantly when the public comes to anticipate a sharp currency devaluation after a period of exchange rate fixity.

The essays by Nissan Liviatan and by Michael Bruno analyze in a theoretical fashion the key relationships relevant to an economy that is subject to real and financial shocks. Liviatan studies these problems from the perspective of indexation arrangements. He asks: Does indexation make any difference to the operation of the economy? His conclusion is that private parties will choose optimal—less than complete—indexation arrangements that reflect their ability to diversify certain risks in labor and capital markets through portfolio selection. Importantly, the paper concludes that full indexation is in general *not* optimal. Bruno's paper deals with the following questions: What are the real and financial characteristics of a semi-industrialized country that are especially relevant to the international linkage? How do these characteristics interact with the exchange rate regime and with economic openness in affecting the impact of disturbances and the scope for macroeconomic management? This is a natural setting in which to explore not only the choice between accommodation or moderation of domestic and external shocks, but also the choice between exchange rate policies ranging from exchange control and dual rates to fully fixed or fully flexible rates. While theoretical in its approach, the paper is nonetheless highly relevant in its policy implications. Indeed, it is very much inspired by Israel's experience with these problems.

Two papers focus on Argentina and the extraordinary events that have unfolded in the past four years between stabilization and collapse. Guillermo Calvo concentrates on the problem of exchange rate overvaluation between 1976 and 1980. Through what channels—real and financial—is it possible to explain the large increase in the exchange-rate-adjusted level of prices in Argentina compared to the outside world? Was the phenomenon a reflection of slow domestic adjustment to inflation—a disequilibrium situation—or was it rather an equilibrium real appreciation? This is, of course, a very important question in the Argentine context. But it is important too in understanding the experience of Chile, which also has pursued a disinflation policy centered around a preannounced exchange rate path. The work of Domingo Cavallo and Humberto Petrei is concerned with the implication of extremely high *real* interest rates in Argentina. How have these high real interest rates on financial capital

affected the profitability and ultimately the viability of private business? Remarkably high real rates have been a feature of stabilization programs in most Latin American countries, and one must ask how financial rates can move so far out of line with any reasonable expectation of the productivity of capital. One cause might be a sharply contractionary monetary policy. But another cause, perhaps more consistent with subsequent experience, is the expectation of a reversal of policies and a resumption of inflation.

Mexico is again the subject in the papers by José Lizondo and by Robert Cumby and Maurice Obstfeld. The approach is empirical and the question is the exact extent to which Mexican financial integration with the U.S. capital market provides scope for domestic credit policy. This is, of course, a question of central importance to policymakers, and these studies approach it through a careful analysis of data and institutions, coupled with econometric sophistication. Lizondo explores the large deviations from covered interest parity, finding that bank regulations and the taxation of capital gains due to exchange rate movement can account for most of the observed covered interest differentials. The Cumby-Obstfeld study uses an empirical structural model of Mexican financial markets to investigate the capital account offset to domestic credit policy under fixed exchange rates. The authors conclude that although the offset was substantial during the 1970s, the Banco de México did possess some short-run control over the money supply.

Olivier Blanchard takes up the subject of Brazil's external debt. To analyze solvency risk, Blanchard develops and simulates a formal growth model. Two main conclusions emerge: First, that there is no debt problem. Second, that current account adjustment, if it occurs at all, should come at the expense of consumption rather than at the expense of investment. The paper's approach may well be controversial, but it does provide a refreshing contrast to traditional country risk analysis.

The volume concludes with a panel discussion of capital markets under conditions of high and varying inflation. In informal statements, the panel brings up many of the issues that remain on the agenda for future research.

At first sight, this book suggests a diversity of topics and approaches, ranging from wage indexation to Mexican offset coefficients and from country studies to purely theoretical models. But that apparent diversity should not conceal a basic unity: All of these papers address issues of financial integration in the world capital market from a common and shared conceptual framework, and they are all concerned with live policy issues.