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**From the Boom in Capital
Inflows to Financial Traps**

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Introduction

In this paper we examine the performance of highly indebted countries from the point of view of their links with the international financial market. The paths followed by some countries in the globalization process led them to situations of segmented integration. Persistently high country risk premiums place the country in a sort of financial trap, with high interest rate and low growth, highly vulnerable to contagion and other sources of volatility and imposing narrow limits to the degrees of freedom of economic policy.

We suggest that domestic policy implemented during the process of financial integration, account for most of the variation in the present situation of the different emergent markets.

Although the more analytical parts of the paper do not refer specifically to Latin America (LA) we consider the regional emergent markets experiences as examples and historical background. Two reasons explain this focus. Firstly, LA countries participated in the financial globalization process from the beginning, in the late sixties-early seventies. Secondly, the most important cases of high indebtedness took place in the region.

The paper is divided into three sections. In the first we present the historical background and briefly discuss the nineties domestic policies. In the second section we analyze the links between the country and the international financial market and characterize financial traps. Conclusions are presented in the third section.

1. Latin America in the process of financial globalization

LA countries took part in the financial globalization process as from the beginning, in the late sixties-early seventies. Financial globalization combines two complementary processes. One is the adoption of institutional and legal measures allowing capital to freely flow across borders, namely the capital-market liberalization. The other is the increase in the amount of capital actually flowing between countries.

Those trends were neither smooth nor continuous in the region. The first boom in capital flows into the developing economies came to an abrupt halt with the financial and external crises in 1981 and 1982. The transfer of a large proportion of the private external debt to the public sector - through different mechanisms - followed. Then, an institutional arrangement in which each country's external financing would involve simultaneous negotiation with both creditor banks and the IMF was established. During the rest of the eighties, the region evolved under a regime characterized by two salient features: (i) rationed external financing; and (ii) negotiations with creditors and multilateral lending agencies generally imposed significant net transfers abroad. In this period, some of the capital market liberalization measures previously adopted were overturned. This temporary reversal of financial liberalization and openness was mainly motivated by the need to restrain the explosive trends set by the crises.

Another features of the early globalization period must also be stressed. The first policy experiments involving complete trade and financial liberalization and opening were implemented in the region. Argentina, Chile and Uruguay implemented similar policy packages – the so-called Southern Cone experiments – in the last quarter of the seventies [Frenkel(2002)]. They all ended in financial and currency crises, debt default, and deep recessions.

The region was not untied from the process of globalization in the 1980s. Although it was virtually impossible to obtain fresh voluntary financing, LA countries and the international system still maintained closed links through the negotiated service of the debts they had contracted in the previous period. When, in the 1990s, several of the region's economies, particularly the largest ones, entered a new period of financial boom, they bear the legacy of a large external debt that resulted from their early involvement in financial globalization and the economic disaster it led to.

The region was reinserted into the process in the early nineties and experienced a new boom in capital flows that came to a “sudden stop” [Calvo (1998)] with the Mexican crisis in 1994/95. This time shrinkage period was short and capital flows

resumed with greater weight of foreign direct investment. This cyclical behavior did not reappear after the new shrinkage period triggered by the Asian crisis.

Many participants saw the first boom of the 1990s as an early stage of a long period of growth in capital flows to the emerging markets, as a result of continual financial deepening at a global scale. This was the basic analytical view that predominated in multilateral lending agencies and some governments. Many international investors and financial intermediaries also shared it. It was thought that the process would lead, without interruption, to the complete integration of the emerging markets into a global market. The possibility of a crisis was simply ruled out in this scheme. The possibility of international investors herd behavior was not considered. The phenomenon was familiar to financial markets' analysts, but concepts as sudden stops and contagion effects were born and applied to the international market only after the Mexican crisis [Krugman (1997)].

The scope and magnitude of the first boom in the 1990s was linked to this underestimation of risks by investors, which encouraged the intensity of capital flows. There was a bubble led by Mexican assets. The Mexican crisis and its repercussions exposed both the risks involved and the volatility of capital flows. But it also showed the possibility and effectiveness of an international intervention in an unprecedented scale. The rescue packages allowed Mexico and other affected countries – mainly Argentina – to fulfil all their financial commitments. This set up the environment for a new boom that lasted until the Asian crisis.

The idea that the international financial integration was a cyclical process had become ordinary after the Asian, Russian and Brazilian crises, and hence, a boom was expected. Such was, for instance, the belief of the economic authorities of the Argentine administration that took office at the end of 1999. The optimistic outlook was encouraged by the effectiveness of most interventions by the international lending agencies in order to avoid default, and also by the relatively benign nature of the Brazilian crisis.

However, other events indicated that the process had taken a new direction. Firstly, the volume of net capital inflows did not recover from the low levels registered in 1998. Second, the risk premium remained systematically high for some countries with heavy weight in emerging markets average, above a floor that doubles the values of the premiums observed during previous periods of boom.

New aspects in price dynamics were also revealed by events. Risk premium and private capital movements oscillated at the pace of new forms of contagion. Oil price increases and the NASDAQ collapse in 2000/1 can be quoted as examples (for instance, Mexico's country-risk grew together with the rest of emergent market risk indexes, in spite of being an oil-exporter country).

Reductions in capital flows and innovations in their dynamics were associated with other significant changes that substantially modified the context that had prevailed in the 1990s. Simultaneously, the US ended a long period of growth. And the bubble in technology shares burst, triggering an important negative wealth effect. That bubble had grown parallel to the boom in the emerging markets, and both types of assets represented a new set of opportunities for investments looking for high returns. The restrain in demand for emerging-market assets that resulted from revised income expectations and the losses caused by the fall in the prices of shares were further augmented by the impact of greater uncertainty.

On the supply side, assets issued by regional emerging markets had lost the attractiveness they showed in the early 90s. The external sector of these countries along with their ability to pay their external obligations changed over the decade, largely as an effect of the globalization process itself. The international positioning of the involved economies changed. The counterpart of the net capital flows is a growing trend in foreign capital and international public and private debts. That was reflected in the current account of the balance of payments as a continuous growth in external factor income. In some relevant cases, growth in the capital income account has not been counterbalanced by growth in net exports and it led to structural deficits in the current account. A large part of the problems facing these countries was precisely the result of this mismatch between their financial and trade positions in the global economy.

At the end of the 1990s, in the face of a dried external supply of funds, heavily indebted countries needed desperately to roll over their debt and additional financing to cover the current account deficit, chiefly determined by capital service (interest and profits). In 2001 this situation affected countries like Argentina and Brazil, which account for a large percentage of the debt of emerging markets and of the Latin American debt. At the end of 2002, Argentina was in default on its debt and the market for fresh borrowing was closed to Brazil¹.

Before going to the main issue of the paper, it is worth taking a look at the origins of the differences in the present situation of LA emergent markets.

1. a. The importance of domestic policies during the capital inflows boom periods

In contrast with Argentina and Brazil, other LA emerging markets show more robust situations. Differences in present positions have mainly resulted from the different paths of international integration followed through the nineties. In this point we want to stress the role played by domestic policies applied during that decade in determining such differences.

A closer look finds significant differences in both the pace and nature of the capital market liberalization measures adopted by each emerging market, on the one hand, and in the volume and composition of capital inflows, on the other. Although participating in the same globalization process, these countries have followed different paths towards trade and financial international integration.

The full deregulation of the capital account, fix or quasi-fix exchange rate, real exchange rate appreciation and a passive role of monetary policy characterized the paths that led to high debt and greater vulnerability. Argentina throughout the nineties, Brazil in the 1994-98 period and Mexico until 1995 are examples of these paths.

On the other hand, some sort of capital account regulation, in coordination with a more active monetary and exchange rate policies, developed into more robust situations. Chile and Colombia in the first half of the nineties are examples of this type of path.²

Decisions regarding capital markets regulations were not isolated measures but complementary features of different policy strategies. In the cases where such regulations were implemented, they were intended to allow or reinforce monetary and exchange rate policies focused on growth and price stability without losing sight on the real exchange rate. Chile and Colombia initially adopted crawling bands exchange regimes, regulated capital flows by imposing tax rates differentiated by type of flow – which meant that some control had to be maintained over the foreign exchange market – and implemented sterilization policies. On the other hand, in the cases where the capital account was completely deregulated, the economic policy was oriented towards full integration with the international financial system and the capital inflows were an essential component of those policies.

Chile and Colombia, on the one hand, and Argentina and Brazil, on the other, are examples of different integration paths closely correlated with different policy

strategies. The Mexican experiences in the nineties encompass both kinds. Its experience in the first half of the decade undoubtedly belongs to the second group, both regarding policy and performance. In contrast, in the second half of the decade the country has followed a different path, with higher rates of growth and an impressive increase in manufactured goods exports, that led the economy to a comparatively more robust situation at the end of the period. We could group Mexico in the second half of the nineties together with Chile and Colombia while Mexico of the first half belongs to the same group as Argentina and Brazil.

That classification of experiences and policies stresses the role of the real exchange rate as a crucial determinant of the difference between the two groups.³ This is so because the only remarkable policy change in the strategy implemented by Mexico after its crisis was the adoption of a floating exchange rate regime, that led to significant exchange rate depreciation in the following three years (not in the whole second half of the decade). This does not mean that the whole improvement of Mexican performance in the second half of the nineties were solely caused by a more depreciated exchange rate. Obviously, the NAFTA and the long period of high growth of the US economy have surely made their contribution. Could Mexico have taken advantage of NAFTA and the US growth if the country had persisted in its previous policy regime? Actually, the crisis made the persistence impossible, but one can imagine that it would have been very difficult for Mexico to reverse the low growth rates and the high trade deficit trends in those circumstances.

2. The financial traps

2.a. The international positioning of emergent market countries

The evolution of trade flows and financial commitments describe the different paths of international integration. The evolution of trade and financial links are important aspects of the development trajectories of the countries. Those are historical processes characterized by path-dependence, in which the conditions found at any moment depend on the earlier course of events. For instance, the external financial commitments resulting from the previous path can impose heavy constraints on the present performance and future evolution of the economy. Certain paths can drive the

economy to a dead end, for instance, a financial trap of low growth and high vulnerability.

The stock of the external debt and the proportion of local capital owned by foreigners are the basic indicators of the evolution of financial commitments. Both are the result of foreign capital inflows that take the form of debt contracts or direct investment (let us include portfolio investment in this category to simplify the discussion).

Trade payments and international financial commitments are generally made and contracted in international currency. In contrast, no emerging-market country issues any international currency and thus their financial commitments are almost always denominated in foreign currency. This point deserves to be stressed. The point is not related to what currency is domestically used to make transactions or endorse local contracts. The observation is valid even in the case of a dollarized economy, like Panama.

The path of international integration is reflected in the changing structure of the balance of payments. In the process of financial globalization, the accumulation of debt commitments and foreign direct investment implies a growing deficit in the capital services payments item (interests and profits) of the current account. On the other hand, the evolution of the trade account balance is a consequence of the path of trade integration, which evolves more or less independently – without coordination - of the financial integration process.⁴ Moreover, as we mentioned above, a badly managed boom in capital inflows can significantly deteriorate the trade performance of the country throughout its effect on relative prices and incentives. Besides, the volume and structure of the external debt determine the committed amounts of capital amortization payments.

The sum of the capital amortization payments plus the current account balance amounts to the so-called “financing needs,” i.e. the amount of international currency liquidity needed to meet international payments in certain period, say, a year.

Aside from its own reserves, the country can obtain the international currency needed to meet its financial commitments from four different sources: 1) trade surplus; 2) the transfer of the ownership of existing domestic assets; 3) new investment financed by foreigners; and 4) new foreign debt. The last three categories entail new capital inflows.

On the one hand, financing needs point to measure the amount of new capital inflows needed to endorse international payments, under the current trade trends and policy setting and maintaining stable reserves. On the other hand, the concept also measures the necessary adjustment that the reserves and/or the trade balance have to experience in case there are no new capital inflows.

In the real world there is no mechanism able to coordinate in every circumstances the myriad of individual decisions involved in the above mentioned transactions, in order to assure the ability of the country to endorse its international payments commitments.

A priori, the rate of interest and the exchange rate would be the main candidates to perform the coordinating role, as flexible prices capable of equilibrating the demand and supply of foreign currency. The role of the first variable is limited, because we know both from experience and theory [Stiglitz and Weiss (1981), Jaffe and Stiglitz (1990)] that the international financial market may at times ration the supply of new funds, precisely when the interest rate of the country's assets reaches some (high) level. On the other hand, given the constraint on new foreign funds, an adjustment exclusively based on the exchange rate depreciation could be at times impossible or intolerable.

In other terms, the capital inflows may at times experience "sudden stops". In this case, the endorsement of international commitments would require an adjustment in the trade balance and/or the level of reserves. Reserves could be insufficient, or a significant decline could trigger a speculative attack. The increase in the trade surplus throughout the depreciation of the exchange rate may have an upper limit, because exports cannot expand sufficiently or imports could not be reduced beyond some limit without affecting exports-production capacity. Besides, the contraction in consumption and/or investment could also affect the production of exportable goods or be socially intolerable. Even if there are not binding real constraints, the necessary adjustment of the trade surplus may not be feasible for other reasons. A very high nominal depreciation has a negative effect on indebted firms and the balance sheets of the banks and consequently, a destabilizing impact on the financial system. The financial crisis would be in that case a self-defeating effect of the devaluation on the ability to endorse international payments.

If there is not enough availability of international currency to meet the country's obligations, some of the contracts have to be defaulted. This may happen independently of the particular financial situation of the domestic agent engaged in the international

contract. For instance, a firm can be able to meet an international interest payment commitment at the current exchange rate, but the government can suspend convertibility to make financial transactions. The government could appeal to convertibility suspension in order to avoid the depletion of reserves - in the case of a fixed exchange rate. Or to avoid a financial crisis and slow down the acceleration of inflation (in the case of a floating exchange rate).

So, international contracts involving developing countries almost always carry a specific country-risk of default. It is imposed by the potential inability of the country to meet its obligations in international currency. It reflects the potential lack of international currency liquidity at the country-aggregate level.

Solvency considerations are not entirely useful for the purpose of assessing the country-risk of default. Sustainability is a more relevant concept. In this context it means the ability of the country to fulfil its financial commitments as they are written in the involved contracts. External debt sustainability means that no serious difficulties should be expected for the attainment of the contracts in due time. Obviously, sustainability is not a guarantee that the contracts will actually be fulfilled. As other financial concepts, sustainability is an assessment about future uncertain events, based on present information and probable conjectures.

An international investor has to evaluate both the prospects of the capital inflows and the ability of the country to make necessary adjustments in trade account and reserves while assessing the risk of default of a particular country. Obviously, possibilities are related to the quantities involved. For instance, usual indicators compare financing needs (or some components of financing needs, as current account deficit, or interest plus amortization) with the amount of foreign debt, reserves, exports and output. The first indicator focuses on the international market capacity to absorbing new country debt. The second points to immediate liquidity availability and to how long could the country endorse international payments without new capital inflows. The third and fourth point to estimate the relative size of the trade adjustment, as an essential ingredient of feasibility considerations. Other usual inputs of the assessment are the situation of the financial system and the specific situation of particularly important agents or debtors, for instance, the public sector.

Domestic information cannot provide a complete assessment of the risk, whatever the amount and detail of the collected information and the sophistication of the models used to evaluate it. Even the quantitative components of the sustainability

assessment depend on the behavior of the international market. Present and expected interest rates and country risk premium are necessary information to forecast the evolution of the debt burden and the future financing needs of a specific country. The amount of new debt that has to be issued in order to meet its financing needs depends on the country risk premium. A higher country risk premium implies that a greater amount of debt have to be issued to get certain net amount of international currency. This is one of the ways in which the sustainability assessment depends on the behavior of the market. Because of that, an increase in the country risk premium caused, for example, by a contagion effect, can substantially change the assessments of external debt sustainability.

Because the prospects of capital inflows and country risk premium are essential components of a sustainability assessment, each of the investors has to conjecture the behavior of the rest of the market. Consequently, there is room for multiple equilibrium and self-fulfilling prophecies, as in most of financial markets. But beyond this general observation, different situations can be identified in this regard.

2.b. The more robust situations

If the above mentioned quantitative indicators are relatively low and there is real and exchange rate flexibility to perform any needed non disruptive adjustments, the fundamentals component of the assessment will point to a low risk of default. At the same time, the evaluation by an individual investor does not greatly depend on the behavior of the rest of the market. Fundamentals are, in this case, the main component of the risk evaluation process. Each investor can presume that the market will easily back the financing needs. And, in case they are not, the necessary adjustment will take place. Thus, the risk of default is low.

Under the mentioned conditions, low risk fundamentals coordinate a good equilibrium. This equilibrium seems robust, but this is not always the case. Experience shows that a contagion effect, even with unaffected fundamentals, can trigger a significant reduction in capital inflows and push the country into important adjustments. However, the country could carry out the adjustment and avoid default. This does not mean that there are not negative impacts on growth and employment. Capital flows volatility imposes high economic and social costs in this case as in other cases [Stiglitz(2000)]. But here we want to stress its financial aspects. Even though there is no

guaranty of the stability of this “good equilibrium”, the situation is more robust than in the highly indebted cases. In the set of LA countries considered above, the description applies to the international positioning of Chile, Mexico and Colombia.

2.c. The more fragile situations

We examine now the case of a country whose fundamentals show a relatively high risk. Financing needs are relatively high and there is less room for non-disruptive adjustment. In this case, the individual investor assessment of the risk of default heavily depends on the behavior of the rest of the market. To clarify this point it is useful to consider the managing possibilities of the main components of the financing needs: trade deficit, foreign capital profit remittances and the aggregate of interests and amortization payments. The classification points to differentiate the components on how manageable they are by the country’s authorities or to what extent they are responsive to domestic variables.

The trade account balance is the most manageable and responsive component. A country can devalue – with the above mentioned caveats - or implement other measures intended to reduce the trade deficit or generate trade surpluses.

The remittances of foreign capital profits rank second in this scale. Exchange rate devaluation reduces the international currency value of foreign capital profits in non-tradable activities. Besides, the country’s authorities could incentive the local reinvestment of foreign-firms profits, negotiate with foreign firms a suspension of remittances or directly impose restrictions. In any of these alternatives, this component of the financing needs would be backed by foreign direct investment without affecting the country’s foreign currency liquidity.

Lastly, the debt services and amortization component is mostly beyond reach of the government policies. Currently, this is particularly true, since most of the external debt has been placed through bonds and commercial papers that are traded in a secondary market and held by numerous bondholders. (In this respect, bank debt is more manageable because banks are more prone to individually renegotiate their credit contracts when difficulties in debt servicing are foreseen.)⁵ The debt services and amortization commitments have to be fulfilled or defaulted.⁶ In this regard, the debt burden is an inertial component of the financing needs because its amount is a consequence of contracts subscribed in the past.

The composition of the present and forecasted financing needs informs about the proportion that should inescapably be backed by new lending in the international market, even after correcting policy measures and feasible adjustments have been taken. When the debt burden accounts for the bulk of present and projected financing needs, the effects of domestic policy measures and adjustment on the financing needs are relatively small. Consequently, the individual sustainability assessment depends in this case mostly on conjectures about the behavior of the rest of the financial market (including, to be more realistic, the behavior of the IMF and other multilateral lenders).

Sustainability is then a self-fulfilling prophecy of the average opinion of the market. The average opinion can suddenly change from sustainable to unsustainable. The changes can be triggered by relatively small variations in the country risk premium, trade prospects or other news affecting the fundamentals. Or the change can be caused by domestic or international news less connected with the fundamentals. The sufficient condition for that to happen is a conventional opinion shared by most of the market participants. Consequently, sustainability is more vulnerable to contagion effects or other sources of volatility, international or domestic.

2.d. The constraints to domestic policy

The valuation of the assets issued by a country in the above situation is a neat example of the Keynesian beauty contest. What can this country do to make their financial assets look more beautiful? The government domestic policies have relatively little room for improving the fundamentals in which the sustainability assessments are based in the short run. But this does not mean that domestic policies are irrelevant. They are relevant, not because of their effect on the fundamentals, but as signals to the international market.[Rodrik(2000)] The signals should make the country look more beautiful at the eyes of the average beauty criteria of the market. Signals are intended to convince individual investors that the average opinion will be favorably influenced. So, they have to harmonize with the more generalized conventions of the market participants. For instance, if most of the players think that an agreement with the IMF will favorably influence average market opinion, then, the agreement will actually have a powerful coordinating role. Fiscal austerity measures are valuable signals if, as it is actually the case, generalized conventions see them always positively, even if an

independent analysis could easily show that they worsen the sustainability fundamentals. We will discuss the fiscal issue in more detail below.

The country loses most of its policy degrees of freedom. The external financing becomes the center of the relations of the country with the rest of the world. It also becomes the main focus of domestic policies because it is the most important and urgent government target. The default would be followed by financial and currency crises (or a burst of inflation in a floating exchange regime). Moreover, the anticipation of default would trigger the financial and currency crisis. In any case the crisis would impose a high political cost and consequently, the government perceives the loss of international funding as the most important threat it faces.

Policy signals to the market may be, and usually they are, socially or politically problematic and may actually have negative impacts on the economic performance. Experience shows that governments choose to confront domestic social and political conflicts and risk a worsening of the economic performance to give priority to the issuing of signals to the market. Governments always prefer to play for time. The default and crisis threat is tangible and easily foreseeable, while the local effects of the signals are more uncertain, take more time to appear or simply they are comparatively less costly for the government in the short run.

2.e. The real interest rate and the country risk premium

The loss of policy degrees of freedom is one of the elements of the financing trap. The other element results from the high real interest that the highly indebted country has to bear. High real interest rate is a consequence of the functioning of the domestic open financial market in a situation of high country risk premium. The sum of the international interest rate plus the country risk premium sets up a floor for the local interest rate. As an example we consider the determination of the lending interest rate. A bit of simple algebra is useful to present the issue.

The market quotation of the bonds issued by the country determines their yield i . Let's suppose they are sovereign bonds, to simplify the presentation. Conventionally, this yield can be decomposed in two terms:

$$i = r^* + k \quad (1)$$

In the expression (1) r^* is the yield of the US Treasury bond of the same maturity and k is the country risk premium.

In the first place it has to be stressed that i is the opportunity cost of any foreign investment in the country, to the extent that the asset under consideration, real or financial, is subject to country risk. So, the cost of international credit to local banks or to other private agents should generally be equal or greater than i . In order to ease the discussion of the real interest rate determination we suppose that the domestic financial system is partially dollarized. This means that assets and liabilities denominated in dollars are issued by the financial system together with assets and liabilities in local currency (pesos). Because local banks can buy sovereign bonds yielding i , this rate is the opportunity cost of local bank lending in dollars. Consequently, this rate sets the floor for local lending in dollars, even if the credit has not been funded in the international market. The local lending interest rate in dollars should be equal or higher than i . Let us assume that it equals i .

To determine the rate in pesos the banks have to take into account the expected trend of the exchange rate:

$$j = i + E(e) + \pi \quad (2) \quad \pi > 0$$

In the expression (2) j is the nominal interest rate in pesos, $E(e)$ is the expected rate of nominal devaluation and π represents the exchange risk premium. Let p and p^* represent the local and international inflation rates respectively. We can subtract p from both members of (2) and add and subtract p^* in the second member:

$$j - p = (i - p^*) + [E(e) - p + p^*] + \pi \quad (3)$$

In (3) $j - p$ is the real interest rate in pesos and $E(e) - p + p^*$ is the expected real devaluation rate.

With the expression (3) it is easy to see that the real interest rate in pesos should be equal or higher than $i - p^*$, except in the case of an expected real appreciation trend strong enough to compensate for the exchange risk premium π . We can disregard this case because an expected appreciation trend is not consistent with a situation in which there is a high country risk. Consequently,

$$j - p \geq i - p^* = r^* - p^* + k \quad (4)$$

The expression (4) indicates that the real international lending rate plus the country risk premium sets normally a floor for the real lending interest rate.

We have already mentioned the negative cumulative effects of high country risk premium on external debt dynamics, the evolution of the country's financing needs and sustainability. Persistently high real interest rates, on the other hand, impair the growth

capacity of the country and tend to increase the fragility of the financial system. Low rates of growth or recession trends plus increasing financial fragility further contribute to the worsening of sustainability. Once the country is caught in the financial trap, market forces themselves lead the economy to contraction or low growth and increasing financial fragility. Together with external financial fragility, these trends contribute to increase the likelihood of a crisis.⁷

Actually, most of the high-risk situations led to financial and external crisis. The experience also shows that situations of high country risk premium can last for years. Argentina in 1998-2001 is a clear example in this regard. Argentina was a case of a very rigid fix exchange commitment – a currency board regime enacted by law. Are fix exchange rate regimes a necessary condition for the configuration of financing traps? The Brazilian situation suggests a negative answer. Brazil experienced low growth and high country risk since 1998. This case shows that countries can fall and remain caught in financing traps even if they have already experienced and overcome currency crises and adopted a floating exchange rate regime. It is a neat example of path-dependence. Brazil corrected in 1999 many of the features that characterized its previous policy approach. But it wasn't enough, because the country could not get rid itself of the heavy financial commitments inherited from its previous path. Country risk premium and interest rate remained high and the country did not find a way out of the financing trap.

2.f. The fiscal signals

We have already mentioned that fiscal austerity measures are highly valued by the average opinion of the financial market. On the other hand, the generation of fiscal primary surpluses is also important in the policy packages promoted by the IMF, both in the programs intended to prevent crisis as well as in the post-crisis stabilization programs.

In the beauty contest in which the country is involved, the IMF plays the game side by side with the rest of the market players. But it is also true that the institution has a significant coordination role, not only because of the amount of resources it manages – vis-a-vis the rest of individual players – but because of the importance given by the market to its seal of approval. So, clever IMF officials could blame the incorrect average opinion of the market for promoting inappropriate policies while, at the same time, smart market participants say that they do well following the IMF assessments.

The reduction of fiscal deficit or the generation of a surplus was a crucial component of the IMF stabilization programs before financial globalization. Balance of payments crises were mainly caused by difficulties in the financing of trade deficit. Excessive trade deficit was always attributed to excessive domestic absorption, which simultaneously caused exchange rate appreciation. Sometimes the problem originated in too much expansionary fiscal and monetary policies, and the diagnosis was right. Sometimes the external deficit originated in exogenous negative shocks – for instance, on the terms of trade – and the same diagnosis was wrong. In any case the stabilization program combined exchange rate devaluation with domestic absorption contraction induced by contracting fiscal and monetary policies. With the implicit assumptions of full employment and expansionary effects of devaluation, the main effect of the policy package was supposed to be the change in the composition of aggregate demand. In practice, there was an output contraction and an increase in unemployment in the majority of cases. However, the policy packages reached anyway their most important objective, i.e. the rise in net exports, although mostly through a fall in imports and at the cost of a loss of output (the program was said to “overkill” the target).

Balance of payments crises are now very different. The external financial difficulties of highly indebted economies originate in different sources. It is not a rather simple problem of flows adjustment, but rather a problem rooted in the stocks of debt and foreign capital. Here we discuss the role of fiscal policy in cases where public debt sustainability is a significant component of the country’ external sustainability uncertainties. We consider different scenarios.

The first scenario is one in which the public debt burden represents a significant proportion of the external financing needs. The country can arrive at this situation by different ways. For instance, the external public debt could have been borrowed to finance public sector primary deficits. It has to be mentioned that in LA none of the emergent market countries have followed this pattern, although there is a controversy about the causes of Argentina’s public external indebtedness in the second half of the nineties.

The other possible way to arrive at the above situation is through the cumulative effect of high country-risk premiums. The rise in the country risk premium can originate either in a deterioration of the external sustainability not related to the fiscal performance, or caused by a contagion effect. Given some initial stock of external public debt, high country risk premiums generate a faster accumulation of external

public debt and growing interests payments, even if there are primary surpluses in the fiscal accounts. In this case, fiscal deficits originate exclusively in the interest component of current public expenses.

In the second scenario public debt is not an important component of external debt. Even so, the dubious public domestic debt sustainability negatively affects the assessments of external sustainability. The same distinction of origins of the situation holds in this scenario. Public debt growth can originate either in the financing of primary deficits or it can be a consequence of high domestic interest rates caused by high country risk premiums.

When public debt is a significant proportion of external debt, fiscal sustainability overlaps with external sustainability, whatever had been the way followed by the country to arrive at that situation. If there are doubts about fiscal sustainability, measures intended to reinforce it are directly connected with the fundamentals of external sustainability. The same holds in the second scenario. Measures intended to improve the sustainability of the domestic debt would have a beneficial effect on the external sustainability assessments.

But the measures intended to reinforce fiscal sustainability could not be the same in every case. When the growth of public debt originated in public sector accounts primary deficits, measures focused on generating or rising primary surplus point to the fundamentals of sustainability assessments. Even though, they not always are the correct treatment. The recessive effects of the measures could deteriorate the sustainability of private external debt while recession and financial fragility could impair the whole sustainability assessment. Besides, the measures could actually have no significant effect on the fiscal accounts, because the effects of recession or lower growth on collected taxes neutralize the impact of the policy measures.

An alternative case is when there is a primary surplus in the public sector accounts and doubts on the sustainability of public debt originate in the high country risk premium itself. In this situation the variable that is out of line is the interest rate that the country has to face to back its financing needs. A lower interest rate would reduce the fiscal deficits and the growth of public debt, improving public debt sustainability prospects. From a strict macroeconomic point of view, the only variable that is “wrong” and should be adjusted is the country risk premium itself. Obviously, there is no way to do that in the present setting of international financial markets.

What could be the rationale of rising primary surplus through expense cuts or higher taxes in this situation? First of all, if primary surplus actually rise, public debt sustainability fundamentals may improve. However, governments adopt fiscal austerity measures not mainly because of their effects on the public debt sustainability fundamentals, but as signals to the market. Fiscal signals point to a target that has to be reached well before any quantitative evaluation of the measures' effects is possible. Their main purpose is to gain credibility; namely, preserving or reopening the country access to the markets to back the external financing needs. The issuing of signals bet on a quick reduction in the country risk premium. Sometimes the signals do their short run job (as in Argentina in 2000 and Brazil in early 2003), sometimes they do not (as in Argentina in 2001).

In any case, fiscal austerity measures are not only inappropriate from a macroeconomic and development point of view, but also risky in relation to their own credibility target. The negative impacts on the economic performance, the financial distress and the social conflicts may actually end up worsening the sustainability assessments.

Why do governments take the risks? The situation is worrisome and the administration in charge is responsible for its management. Governments must show action. So, they implement fiscal austerity measures as one of the few ways they have to show policy initiatives "in the right direction". Maybe the same argument is applicable to the IMF policy proposals. IMF lending has necessarily to be submitted to conditionality. When there is no much room for correcting policies and the IMF has decided new lending – Argentina in 2000 is probably the best example - the institution appeals to fiscal contracting measures as a solution to the problem of establishing some conditions for their disbursements. Ultimately, fiscal austerity looks always respectable and the policy is deeply rooted in the institution traditional orthodoxy.

The suggested explanation can shed some light on the more intriguing case of IMF fiscal austerity measures recommendation: the situation in which there are not fiscal sustainability problems nor even significant public debt. In this case the norm followed by IMF officials seems to be the following: if you don't know what to do and you have to do something, raise taxes and reduce public expenses. The justification of this orientation would be an archaeological residual of the pre-globalization period.

2.g. Segmented integration

The paths of international integration followed by the highly indebted countries led them into situations of segmented financial integration in which the domestic rate of interest is significantly higher than the international rate.

Persistently high country risk premiums are an unforeseen effect of financial globalization. Since the process begun, its advocates have presented full integration between the domestic and international financial markets as its ideal final stage. Full integration is tantamount of global financial intermediation whereby the yield on the assets, on the one hand, and the cost of capital for borrowers, on the other, are the same for economically equivalent transactions, regardless of the location of savers and borrowers.

Ideally, full integration would minimize intermediation costs and reduced the cost of capital to developed country levels. Assuming that developing countries offer grater opportunities for investment, full integration would also result in investment and financing flows tending to narrow the development gap.

Convergence towards full integration would have meant a continuous reduction in country risk premiums. This has not happened. The evolution of country risk premiums provides no evidence to suggest that the international system that has developed along with globalization is tending towards a full financial integration. Quite the contrary, the experience of the period that began with the Asian crisis suggests that the system has evolved into segmented integration. The cost of capital is systematically much higher for some emerging market economies than for the developed countries. Segmented integration is not a marginal phenomenon, it has developed precisely in emerging market countries that concentrated an important proportion of capital flows.

3. Conclusions

Capital flows volatility imposes high economic and social costs to every country participating in the system created by the financial globalization process, despite its particular situation. However, some countries have managed their insertion in such ways that they show more robust situations vis-a-vis international financial markets. In contrast, other important emergent market countries found themselves caught in financial traps.

The comparative analysis of Latin American experiences, together with the negative and positive lessons learned from other cases, makes it possible to extract a series of policy recommendations to avoid the riskier paths of international integration.

First, there is consensus regarding the importance of prudential regulations. However, the conventional criteria for regulation are largely procyclical. Besides microeconomic risks, prudential regulation should also consider the macroeconomic and systemic risks, such as mismatches in currencies and the stockpiling of debt in foreign currency. [Ocampo(2003)] Moreover, the burden from prudential regulation should be distributed beyond recipient countries and shared by developed countries.

Second, experience leaves no doubts as to the incompatibility between fixed exchange rates and the volatility of capital flows. Nevertheless, although there is consensus regarding the need for exchange rate flexibility, there is an open debate on the possibilities and benefits of intervening in the exchange market. The IMF advocates pure flotation and assigns all responsibility for price and exchange rate stability to monetary policy. A flexible exchange rate discourages certain types of short-term capital flows, but free floating in contexts of volatile capital flows can result in intolerable volatility in the nominal and real exchange rates. Besides, policies should never lose sight of the real exchange rate. Application of direct controls – or application of reserve requirements to the entry of capital as Chile and Colombia did – [French-Davis and Villar(2003)] can contribute to the stability of the exchange market and the capital flows. It can also influence the duration of inflows by discouraging short-term investments. Aside from its role as short-term stabilizer, the objective of regulatory policy is to harness capital inflows to turn their behavior into a stable and predictable flow.

ECLAC has been a leader in promoting the mentioned policy outlook and approach.[ECLAC (2000), (2002)] The so-called crisis-prevention measures incorporate the lessons that can be learned from the region's experience, but their implementation is most suitable for periods of capital inflow booms. Besides, even optimal domestic policies can not guarantee robustness. Moreover, even countries in relatively robust situations cannot avoid significant real effects from capital flows volatility.

Under the current international financial architecture, once a country has fallen into a financial trap there is no mechanism able to take it out. [Eatwell and Taylor(2000), Stiglitz(2002)] Massive rescue packages led by the IMF were the only

policy initiative at the international level in this area. In fact, they contributed to avoiding default in most cases. But, the existence of this policy instrument did not impede the outbreak of crises and, particularly from the Russian crisis, did not prevent persistently high country risks and the development of financial traps.

To make things worse, rescue packages are no longer allowed while the new IMF initiative pointed towards an international reform with the exclusive purpose of facilitating post-default negotiations. Even this very limited initiative has not prospered. The prospects of high-risk countries are not encouraging.

Notes

¹ In April 2003 the market for Brazilian bonds was reopened. The government issued one billion dollars of new debt at an annual cost of 10.7 %.

² The differences in policy strategies vis-a-vis financial globalization are related to the different priorities posed by the macroeconomic situation at the end of the eighties. Mexico, Argentina and Brazil had to control inflation and recover growth after a long period of very high inflation and stagnation. In contrast, in Chile and Colombia inflation was under control and the economies were growing at relatively high rates. [Damill, Fanelli, Frenkel y Rozenwurcel (1993); Frenkel (1995)]

³ In comparison with the average real exchange rate of the second half of the eighties, in the period 1991-94 Chile and Colombia appreciated significantly less than Argentina and Mexico. [Frenkel (1995)]

⁴ In the mainstream literature of the eighties this was seen as a problem related to the sequencing of the structural reforms. [McKinnon (1991), Fanelli and Frenkel(1993)]

⁵ For example, the standstill on short-term debt negotiated in the crisis by the Korean government would have been practically impossible if short-term obligations were bond services instead of bank debt.

⁶ There is another alternative: bondholders could agree in voluntary swaps intended to reducing liquidity needs and avoiding formal default. Let us consider this alternative as default, for the purpose of this discussion.

⁷ We have formulated a model of the macroeconomic dynamics generated by capital inflow booms in fix exchange rate contexts. There is a cycle with a first expansionary phase, followed by domestic financial distress and a second phase of contraction that leads to a final financial and currency crisis. The rise in the real interest rate is an endogenous consequence of increasing external fragility. The model was inspired by the Argentina and Chile experiences in the late seventies-early eighties [Frenkel (1983), Williamson (1991)]. It was applied to explain similar crises in the nineties. [Frenkel (2002), Taylor (1998), Eatwell and Taylor (2000), Frenkel (2003)].

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