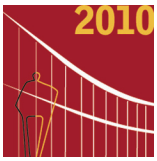


Chapter II

Macroeconomic policy for development: moving on from lessons learned and charting a new course

A. Introduction

The Latin American and Caribbean region has the capacity to achieve greater and better quality growth. The region's economic performance needs not only to be more robust but also to ensure greater levels of inclusion, social equality, productive investment and quality employment, and less exposure to the impact of external volatility.

This is no easy task. Sound policies must be adopted on various fronts, notably at the macroeconomic level. As demonstrated by recent events, which are reviewed in this chapter, this policy is not neutral vis-à-vis economic trends and social inclusion. On the contrary, there is a significant link between its thrust and the sparse and volatile pattern of development in the region, the limited flows of investment in productive enterprises and the scant increase in productivity.

Production and employment have been subject to the sharp cyclical fluctuations of global demand and exchange rates, which are key variables in the macroeconomic environment in which the producers of goods and services operate.

This environment is determined by the interaction between fiscal, monetary, exchange-rate and domestic market and balance-of-payments financial account policies, on the one hand, and external market forces, on the other. In turn, the macroeconomic context has an impact on the pace of economic growth and the distribution of its fruits, which have implications for the labour situation and the strength of social policy.

The current global crisis strengthens the arguments relating to the fundamental role of the style of macroeconomic policymaking and the importance of assessing the shifts that will need to be made in existing practices. A crucial leap forward needs to be made in macroeconomic policy

and the approach to be adopted must explicitly prioritize productive development and level upwards capacities and social opportunities. This will reduce productivity gaps, which should pave the way for a reduction of inequalities. For this to happen, stability must be seen as more than control of inflation; it must be conceived as functional for development, and the over-compartmentalized vision of micro- and macroeconomics must be replaced with a integrated approach that takes into account the interaction of the two.

These interactions have static and dynamic impacts. Among the former is the rate of utilization of available production capacity (both labour and capital), since fluctuations in this rate have frequently left large gaps between installed capacity—or potential GDP— and real GDP. These gaps and the volatility of variables such as the real exchange rate then generate dynamic effects through the multiple impacts of the macroeconomic environment: on the investment rate and how it determines future development, on the intensity of value added generated by exports and the way it interacts with the rest of domestic production; on innovation; on the development of small and medium-sized enterprises (SMEs); and on the formality or precariousness of the labour market. In short, the style of macroeconomic policy has a significant impact on all of these variables —which determine the momentum and quality of development— and is largely responsible for the modest growth in regional GDP in the period 1990-2008: 3.2% per year. To the extent that this lack of dynamism is also associated with a rigid pattern of diffusion of capacities and opportunities, it is also responsible for the enormous productivity gaps that have been reproduced between groups and persons and for the perpetuation of social disparities whose scale gives Latin America and the Caribbean the dubious honour of being the most inequitable geographic region in the world.

Although inflation has, to some extent, been brought under control and greater fiscal discipline has been introduced, steps must be taken to create a more favourable macroeconomic environment for the various agents of economic development, that is, those that generate GDP. Firms, employers and workers have had to cope with considerable instability in aggregate demand, access to credit and real exchange rates, and this has undermined capital formation, employment and productivity. In this regard, financial capital flows have played a central role.

Section B of this chapter reviews the various achievements and shortcomings of the Latin American and Caribbean economies since the early 1990s. On the one hand, it points to the successes in terms of control of inflation, fiscal discipline and export growth. On the other, it shows that GDP growth and productive investment have been insufficient and were hampered by macroeconomic policies that were poorly coordinated with each other and with the business cycle.

Section C examines the reasons for this poor performance. Clearly, outcomes were closely associated with the highly unstable aggregate demand and exchange rates that different agents had to contend with. This instability was due, above all, to recurrent external shocks, which restricted capital flows and, more recently, caused a deterioration in the terms of trade. Such shocks are not usually neutral in terms of the way costs are distributed over time and between different socio-economic groups. It has taken much longer to reverse the social deterioration caused by these shocks than it has for the economy to reverse the declines in per capita GDP. This was the case following the debt crisis of the 1980s. The result is a deterioration in income distribution and heightened social vulnerability.

Section D examines the effects of instability, in particular the generation of recessionary gaps between potential GDP —or the production frontier— and real GDP. As we shall see, these

gaps have an adverse effect on companies' balance sheets and expectations, as well as on employment. Particularly in the last few years, the instability of economic activity has been due mainly to underutilization of the capacity to produce for the domestic market, which now accounts for approximately 80% of regional GDP. This is the portion of GDP that is most dependent on the national macroeconomic performance, which is the subject of this chapter. The chapter then goes on to consider the impacts of frequent recessions, which result in lower rates of productive investment and fewer sources of employment. This not only leads to higher unemployment and, consequently, more widespread poverty, but also greater informality, which reaches very high rates among the economically active population of the countries of the region and accounts for the structural heterogeneity and the reproduction of inequalities. This heterogeneity is addressed in greater detail in chapter III.

Section E presents lessons and policy proposals for a macroeconomic approach to development, based on fiscal, monetary, exchange-rate and capital market policies, including the national financial system and the external financial account. The central message is the need for coordinated management of all these areas of economic policy so that the macroeconomic environment stimulates capital formation, innovation and robust creation of quality jobs.

B. Achievements and shortcomings of macroeconomic reforms since the 1990s

1. Achievements

The Latin American and Caribbean region has been the scene of spiralling inflation with clear episodes of hyperinflation, as in 1990 when the average rate of inflation stood at 1,667%.[1] In many cases, the excessively high inflation was due to huge fiscal disequilibria and the financing of deficits through money creation, which rapidly threw aggregate demand out of balance with production capacity. Hence, many countries in the region exhibited sharp macroeconomic disequilibria based on shortcomings in their internal management. These were compounded by terms-of-trade shocks: with exports limited to just a few resource-based commodities, whose prices were highly volatile, these countries faced sharp fluctuations in the availability of foreign exchange. In the absence of stabilization funds, this instability had a cyclical impact on aggregate demand and the exchange rate.

Macroeconomic instability, caused by short-termist policies and policies formulated in response to contingent pressures, whether economic or political, has tended to generate levels of uncertainty that undermine productive investment and growth (ECLAC, 2008b). One of the usual manifestations of this instability has been the volatility of relative prices associated with steep inflation, which, as demonstrated by experience in the region, tends to shorten hiring and decision-making horizons, hinders channelling of savings towards investment and impairs the quality of the information derived from the pricing system. In short, this volatility makes it well-nigh impossible to evaluate investment projects accurately.

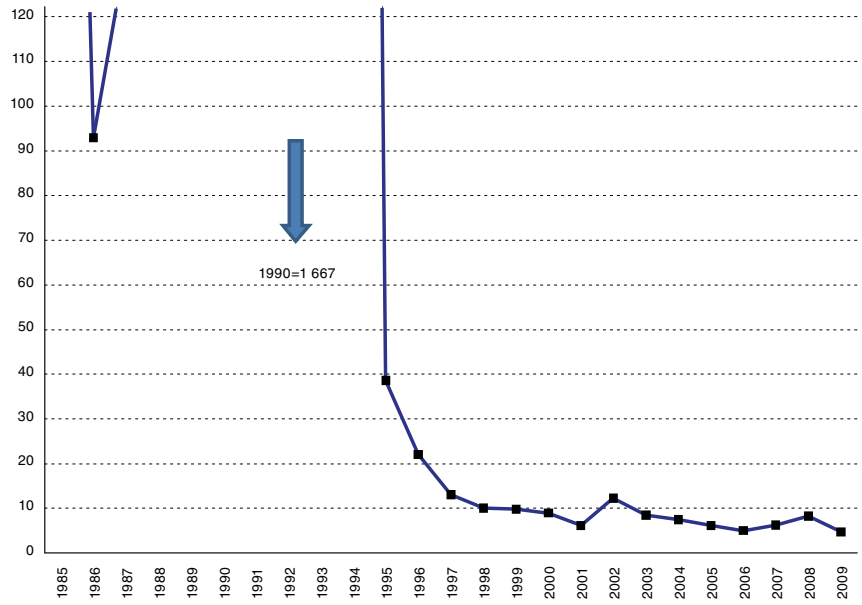
[1] The regional average —taking into account 19 countries— weighted by the population is 1,667%, reflecting inflation of more than 2,000% in Argentina and Brazil and of 7,500% in Peru and Nicaragua. The simple average for the region in 1990 was 1,087%.

Directly related to this instability is the solvency of the public sector, which, as the region's past experience has demonstrated, is a crucial issue. Budgetary constraints experienced by the Government usually manifest themselves as pressures on the monetary authority. The economic policy objectives and modalities for action must be clearly defined in order to limit uncertainties, expand decision-making horizons and coordinate forecasts appropriately. This includes presenting a relatively foreseeable inflation panorama as a public good.

Conscious of the sources of macroeconomic instability, the reformists of the 1990s prioritized fighting inflation and imposing fiscal discipline at the same time as they sought to protect monetary management against pressures and direct it towards the pursuit of moderate, non-volatile inflation. Indeed, monetary policy would often operate independently of the other areas of macroeconomic policy and its sole or priority objective would be to bring inflation under control.

Towards the mid-1990s, the authorities had succeeded in reining in inflation and, since 1997, the annual rate has come down to single digits (see figure II.1).

Figure II.1
LATIN AMERICA (19 COUNTRIES): ANNUAL INFLATION RATES, 1985-2009 [a]
(Percentages, December to December)



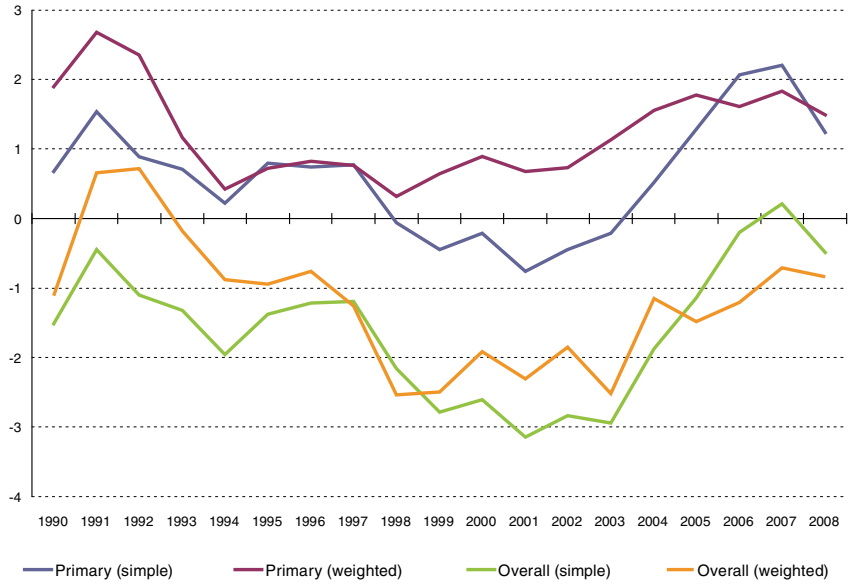
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The figures for 2009 are preliminary.

The control of inflation was associated with variables designed to stabilize price levels and correct market functioning. The substantive improvements in fiscal balances were instrumental in achieving this, especially in economies that had suffered from hyperinflation. Budget management and fiscal savings improved considerably: in the five-year period prior to the contagion caused by the 1998 Asian crisis, the fiscal deficit averaged only 1.5% of GDP —compared with 3.9% in the 1980s— and worsened as a result of the crisis, before returning to more manageable levels and continuing to improve since 2004 (see figure II.2). On average, the region maintained primary

surpluses for several years, which enabled some countries to use the unexpected fiscal revenue associated with rises in export earnings to set up stabilization funds. In turn, expansion of the money supply to finance the public deficit —a frequent cause of hyperinflation in the past— had almost ceased and the deficits, already much diminished, were financed through the financial market.

Figure II.2
LATIN AMERICA (19 COUNTRIES): CENTRAL GOVERNMENT PRIMARY AND OVERALL BALANCE, 1990-2008 [a]
(Simple and weighted averages as percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Simple averages of the 19 countries and averages weighted by real GDP. The coefficient of correlation between the two curves —the primary deficit and the overall deficit— is 67% and 71%, respectively.

Furthermore, since the 1980s, exports have expanded rapidly in volume terms —almost one and a third times as fast as global trade— and, in terms of products and destination markets, have become slightly more diversified, which has allowed a number of countries to build up substantial international reserves.

The proponents of an "orthodox" approach were confident that with these three significant achievements —control of inflation, improved fiscal balance and export promotion— economic growth would pick up spontaneously, while the degree of government intervention in the markets of the region would diminish (Burki and Perry, 1997; IDB, 1997). The strong moves to liberalize imports, domestic financial markets and financial accounts played a strategic role in promoting development in parallel with macroeconomic achievements.

2. Shortcomings from the development perspective

The vast majority of countries in the region complied with the requirements for macroeconomic equilibrium set out in what became known as the Washington Consensus. The results in terms of economic growth and social equity were paltry, however, although the upturn in 2004-2008 did

bring some improvement. Annual growth averaged barely 3.2% in 1990-2008 (see table II.1). Annual per capita GDP growth in this period was a meagre 1.7% in the region, well below the rate recorded in East Asia (4.1%) but the same as in the United States, where per capita income is five times as high as in Latin America and the Caribbean.[2]

The background to these unstable GDP results and their adverse effects are proof that the macroeconomic policy, which targeted the two above-mentioned pillars —low inflation and fiscal discipline— was unsatisfactory in developmental terms. As regards macroeconomic equilibria, the GDP growth rate has fluctuated sharply in most countries of the region, not so much because of sudden structural or microeconomic changes as because of other macroeconomic variables associated primarily with financial capital inflows and outflows, which are reflected in substantial variations in aggregate demand, the exchange rate and expectations or the sentiment of economic agents.

Indeed, the cyclical variations in these inflows and outflows of capital were the macroeconomic variable that contributed most to the recessionary gaps in the period 1990-2009. The resulting instability has a strong regressive impact on social conditions and equity. In this regard, volatility may be said to have had a punitive effect on the most vulnerable sectors and to have distributed costs and benefits in a highly uneven way.

Thus, in 2008, the average real wage barely exceeded the level observed just before the debt crisis in the early 1980s. The slight 0.7% yearly increase in GDP per worker in 1990-2008, as indicated in table II.1, does not seem to be reflected in any substantial rise in wage income, despite an appreciable increase during the period 2003-2008, which simply compensated for the previous declines. Furthermore, wages reflect developments in the formal segment of the labour market only. More serious is the extent of informal employment, which accounts for approximately half of the economically active population in urban areas. This attests to the precariousness of labour markets in the region. The informal sector expands during recessions and is associated with less secure employment conditions and a deterioration in labour income, as seen during the debt crisis and during the 1998-2003 recession (Tokman, 2004). The significant rally in employment and wages between 2003 and 2008 suggested that the average Gini coefficient in the region would decline by around 4%, compared with that of 2002. However, in 2008, before the outbreak of the global crisis, income distribution continued to be highly unequal (ECLAC, 2008a).

These averages include the recovery attained in the boom period following 2003. During the five-year period 2004-2008, GDP grew on average by 5.3% (a rate not seen since the 1970s), unemployment declined by more than three percentage points —from a regional average of 11% in 2003 to 7.4% in 2008— and wages picked up.[3]

[2] From 1998 to 2008, GDP growth averaged 3.2%, a similar figure to that of the first few years after implementation of the Washington Consensus. In general, it is accepted that reforms require time to take full effect. Notwithstanding the greater maturity of the process during the most recent period, Latin America has not been able to improve on its poor economic or stability record or achieve any substantial improvement in the degree of equity resulting from the functioning of the market.

[3] As the boom was brought to an abrupt halt in 2009 by the global crisis, triggering a fall in production and employment (see table II.1), the present analysis ends in 2008 —when economic activity was at its peak— in order to centre the evaluation and its quantitative data on more structural factors, which reflects more accurately the structural situation up to the start of the crisis.

Table II.1

LATIN AMERICA AND THE CARIBBEAN (19 COUNTRIES): GDP GROWTH, 1971-2009

(Annual rates of variation)

	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Antigua and Barbuda	0.3 [a]	6.8	3.2	3.3	6.7	4.9	4.2	-6.6 [b]
Argentina	2.8	-1.0	5.0	-1.3	8.4	3.0	3.8	0.9
Bahamas	…	…	1.3	2.6	1.6	2.2	1.8	-3.9 [b]
Barbados	3.9 [c]	1.4	0.1	1.2	3.1	2.0	1.2	-3.6 [b]
Belize	5.1 [d]	4.9	2.0	7.3	3.5	5.6	4.1	-0.5 [b]
Bolivia (Plurinational State of)	3.9	-0.3	4.3	2.5	4.8	3.5	3.9	3.5 [b]
Brazil	8.6	2.3	2.0	1.5	4.6	2.9	2.5	-0.2
Chile	2.5	2.8	7.0	2.7	4.8	3.6	5.0	-1.5
Colombia	5.4	3.7	3.9	1.1	5.3	3.0	3.4	0.4
Costa Rica	5.7	2.4	4.7	4.8	5.9	5.3	5.0	-1.2 [b]
Cuba	…	…	-3.3	3.4	8.1	5.6	1.8	1.4
Dominica	…	4.2	3.3	-0.2	4.9	2.1	2.6	-1.5 [b]
Ecuador	9.1	2.1	2.8	2.0	5.4	3.5	3.2	0.4
El Salvador	2.4	-0.9	5.2	2.6	3.3	2.9	3.9	-3.5
Grenada	17.6 [e]	11.3	1.6	5.6	1.8	3.9	2.9	-5.0 [b]
Guatemala	5.7	0.7	4.0	3.5	4.4	3.9	4.0	0.6
Guyana	2.2	-3.1	5.8	0.4	2.6	1.4	3.3	0.9 [b]
Haiti	5.2	-1.0	-0.4	0.8	1.1	0.9	0.4	2.9
Honduras	5.5	2.7	3.3	3.0	5.8	4.3	3.9	-2.1
Jamaica	-0.7	3.1	1.7	1.0	1.2	1.1	1.3	-3.0 [b]
Mexico	6.5	1.4	3.1	2.9	3.5	3.1	3.1	-6.5
Nicaragua	1.0	-1.4	2.4	3.5	4.0	3.7	3.2	-1.5
Panama	5.6	0.9	5.6	3.5	9.2	6.1	5.9	2.4
Paraguay	8.8	3.1	3.2	0.3	4.8	2.3	2.7	-3.5
Peru	3.9	-0.7	3.9	2.0	7.6	4.5	4.3	0.9
Dominican Republic	7.2	3.3	4.5	4.5	7.0	5.6	5.2	3.5
Saint Kitts and Nevis	5.7 [e]	6.3	4.6	2.1	5.1	3.4	3.9	-8.5 [b]
Saint Vincent and the Grenadines	6.4 [f]	6.4	3.4	3.4	5.5	4.4	4.0	-0.2 [b]
Saint Lucia	4.4 [e]	7.4	2.9	1.5	3.8	2.5	2.7	-3.8 [b]
Suriname	2.1 [f]	0.6	-0.5	3.0	4.2	3.5	1.8	2.5 [b]
Trinidad and Tobago	5.3	-2.7	2.9	8.3	6.9	7.7	5.7	-0.5 [b]
Uruguay	2.7	0.4	3.9	-2.1	8.5	2.6	3.1	2.9
Venezuela (Bolivarian Republic of)	1.8	-0.3	3.8	-2.7	10.1	2.9	3.3	-3.3
Latin America (19)	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Total GDP	5.6	1.3	3.3	1.4	5.3	3.2	3.2	-1.8
Per capita GDP	3.0	-0.8	1.5	-0.1	4.0	1.8	1.7	-2.9
GDP per worker	1.7	-1.5	0.6	-1.1	3.1	0.8	0.7	-3.8
Per capita GDP	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Latin America (19)	3.0	-0.8	1.5	-0.1	4.0	1.8	1.7	-2.9
Asia (6)	-	5.6	5.8	2.2	3.9	3.0	4.1	-2.0
United States	-	2.4	1.6	2.0	1.4	1.8	1.7	-3.4
World [g]	-	1.6	0.6	2.0	3.3	2.6	2.0	-3.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official data from the respective countries and information from the International Monetary Fund (IMF).

[a] Refers to the average of the growth rates for the period 1974-1980.
[b] The figures for 2009 are the ECLAC estimates as published in the *Preliminary Overview* 2009 (ECLAC, 2009a).
[c] Refers to the average of the growth rates for the period 1975-1980.
[d] Refers to the average of the growth rates for the period 1977-1980.
[e] Refers to the average of the growth rates for the period 1978-1980.
[f] Refers to the average of the growth rates for the period 1976-1980.
[g] Weighted for each country's relative share at market prices.

The limited average growth meant that the gaps in productivity (see chapter III) and per capita GDP between the countries of the region and the developed countries remained very wide. The data presented in figure II.3 show that in 2008, per capita GDP in Latin America was equivalent to just 27% of that of the Group of Seven (G7) countries and 23% of that of the United States. A substantial social gap also persists, since the ratio of the income of the highest to that of the lowest quintile (Q5/Q1) in the countries in the region is well over double the corresponding ratio for the G7 countries (17, compared with 7). When deciles are used for this comparison, for example D10/D1, the gap is even wider (34 compared with 12) given that in the upper brackets, the income distribution curve is more vertical in Latin America and the Caribbean than in the developed countries. The region continues to be highly regressive compared with other world regions (De Ferranti and others, 2003), and this is linked to its production structures. The great structural heterogeneity between firms of different sizes and between workers with different skill levels builds inequalities into the structure of production and the operation of the markets. As described in chapter III, in order to achieve robust growth, steps must be taken to improve the productivity of the middle class and poor sectors, since inequality and poverty are a drain on economic development (Bourguignon and Walton, 2007). Consequently, the challenge that must be addressed is how to treat growth and the reduction of inequality as firmly complementary rather than contradictory objectives.

The extent of GDP growth depends on several factors, chief among them being the investment rate. Capital formation has been low compared with the rate observed in other successful emerging economies and with the rate achieved in the region in the 1970s. Figure II.4 shows that for much of the time when the Washington Consensus held sway, the investment rate was closer to the low level recorded in the lost decade of the 1980s than to the figure observed in the 1970s, when average GDP growth in Latin America was 5.6%.[4] In 1990-2008, the rate stood at 18.4%, compared with 23.5%, the figure observed in the 1970s. The exception was the period 2007-2008, when the investment rate approached, but did not quite reach, the average for the decade of the 1970s.

Figure II.4 illustrates clearly the importance of continuous recovery paths and sustainable equilibria in closing the recessionary gap. When economic recovery has lasted longer, the investment rate reaches higher levels and tends to be progressive: following the sustained recovery that started in 2003, the biennium 2007-2008 recorded the highest rates since the 1970s. This continuity is key for providing investors with an effective incentive to retain their investments in the country and for mobilizing the long-term credit required by the productive sector.

The global crisis triggered a two-percentage-point fall in the rate of gross fixed capital formation: from 22% of GDP in 2008 to 20% in 2009 and the challenge is now to achieve higher levels of capital formation than in 1990-2009, since this factor is indispensable for achieving growth with equality. Wage levels and income distribution are closely linked to the level of capital stock per worker as well as to the bargaining power of different social sectors, the quality of education and labour training (see chapters V and VI).[5]

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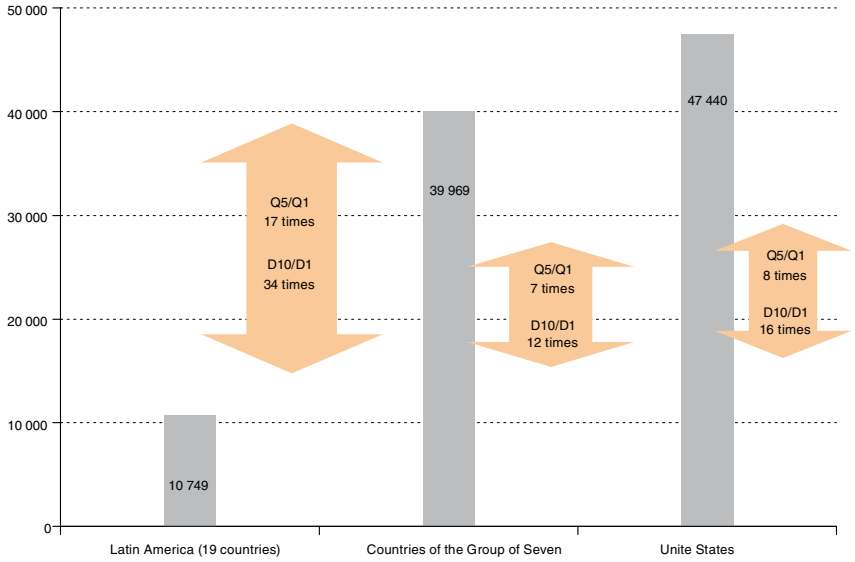
[4] While the Washington Consensus was in force, the investment rate was at its lowest, despite the fact that foreign direct investment (FDI) flows were relatively higher in recent subperiods than in the 1970s. It may be inferred, therefore, that what decreased during that period was national saving and investment (see Ffrench-Davis (2005), table VI.1).

[5] In 2000, capital intensity per worker was US$ 16,000 in Latin America and US$ 111,000 in the United States (Ffrench-Davis, 2005, chapter V).

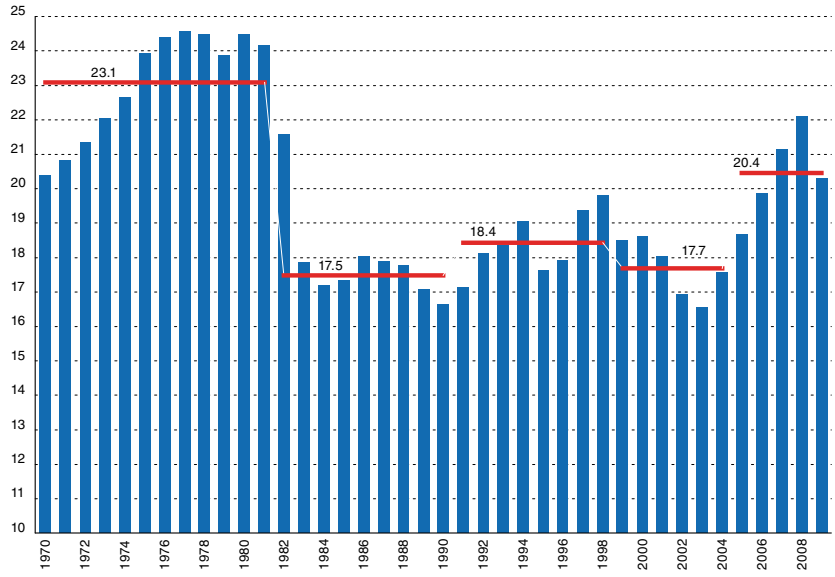
Figure II.3
LATIN AMERICA AND DEVELOPED COUNTRIES: PER CAPITA GDP AND INCOME DISTRIBUTION, 2008 [a]
(Purchasing power parity dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures for Latin American countries; International Monetary Fund (IMF), *World Economic Outlook* [online database] and World Bank, *World Development Indicators*, 2009, for the Group of Seven (G-7) and the United States.

[a] Q5/Q1 and D10/D1 are the ratio of the highest to lowest income quintiles and the highest to lowest income deciles of the population, respectively.

Figure II.4
LATIN AMERICA (19 COUNTRIES): GROSS FIXED CAPITAL FORMATION, 1970-2009 [a]
(Percentages of GDP)



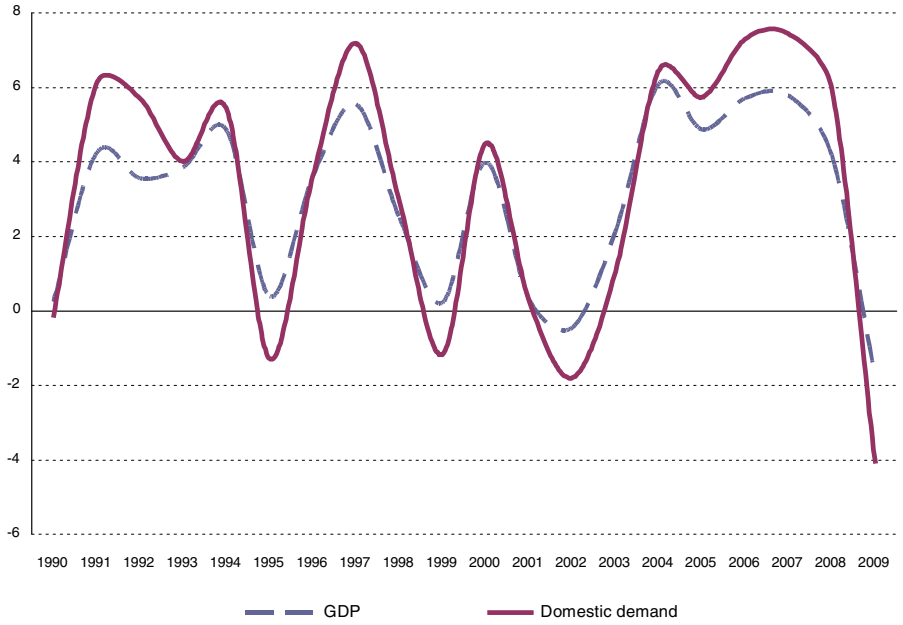
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The figures for 2009 a preliminary. The percentages shown on the horizontal lines are the annual averages for the relevant subperiods.

C. Causes of instability in the real economy

The remarkable success achieved in reining in inflation and improving fiscal responsibility was not sufficient, in itself, to consolidate stability. The performance of the countries of Latin America and the Caribbean gained impetus from a macroeconomic context whose main stakeholders —the State, entrepreneurs, workers and investors— faced considerable fluctuations in aggregate demand, economic activity and macroeconomic prices (ECLAC, 2000, chap. VI; Ffrench-Davis, 2005, chaps. I and II). In this regard, figure II.5 clearly illustrates the wild fluctuations in aggregate demand.

Figure II.5
LATIN AMERICA (19 COUNTRIES): ANNUAL VARIATION IN GDP AND AGGREGATE DEMAND, 1990-2009
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006.

Although economic growth is also influenced by the complex processes relating to micro and meso-economic structures, education, and labour and entrepreneurial training, during this period the volatility and limited growth of production were due, in no small measure, to the macroeconomic situation.

If the economy had been in macroeconomic equilibrium, with no major recessionary gap between real and potential GDP and steadily rising domestic demand —as occurred in 1990-1994, 1996-1997 and 2004-2007— then GDP in the following periods would have been relatively constant, with outbreaks of inflation and a proportional deterioration in the external accounts. On the whole, however, this is not what happened.[6] What did happen was that real GDP increased,

[6] A number of other variables interacted in parallel including currency appreciations, which, naturally, kept prices in check and bias domestic spending towards imports.

which is possible only if there is a gap between potential and real GDP. The conclusion, which has important implications, is that since the 1980s, the Latin American and Caribbean region has remained below the production frontier, with fluctuations that bring it closer to or further from potential GDP. This is tantamount to a serious macroeconomic disequilibrium.

Although fluctuations in aggregate demand in the past were often due to fiscal deficits financed through money creation, generally speaking, it may be stated that more recent variations have been due to external shocks, which have impacted especially the financial account and the terms of trade.

In the years prior to the eruption of the 1995 and 1999 crises, rising current account deficits generally involved surges in net private-sector spending. This was in response to the signals coming from the combination of a strong supply of external financing and lax, procyclical domestic macroeconomic policies (Kaminsky, Reinhart and Vegh, 2004), often lauded by financial markets and risk-rating agencies. The boom in 2004-2008 was associated, however, basically with terms-of-trade gains, but again the private-sector deficit increased. The improvement in terms of trade brought about higher government revenues, with a growing primary fiscal surplus between 2003 and 2007, which enabled Governments to reduce their liabilities and, in some cases, set up stabilization funds. This led the region overall to exhibit a significant surplus in the balance-of-payments current account, which suffered a sharp reversal in 2008-2009 with the outbreak of the global crisis. The pattern in the Caribbean was quite different (see box II.1).

Box II.1

GROWTH OF THE DEFICIT IN THE CARIBBEAN

The unweighted merchandise trade deficit of the Caribbean as a percentage of GDP was 22.3% in the period 1997-2000 and 23.4% in the period 2001-2006. In the case of the Organization of Eastern Caribbean States (OECS), the deficit for these two periods was 34.7% and 35% respectively, reflecting the continued decline in agricultural and manufacturing activity in these economies. In the Caribbean, the current account deficit was 10.7% of GDP in 1997-2000 and 12% in 2001-2006. In the OECS subregion, the percentages were 16.7% and 21.5%, respectively. The situation worsened in the latter period following the rise in food and fuel prices, since these products account for a substantial proportion of the import bill in most Caribbean countries.

In terms of the overall deficit/GDP ratio in the Caribbean, the simple average was 3.6% in 1997-2000 and 3.8% in 2001-2006. In OECS countries, the figures were even higher than the average: 4.1% in the first period and 4.3% in the second. The political responses to these deficits were varied and most spending cuts were made in the capital budget. A few countries had, for various reasons, seen an improvement in their fiscal position. The most notable of these exceptions was Trinidad and Tobago, which saw its surplus grow, but this was due to the increase in oil and gas revenues. Belize, Guyana and Suriname also experienced an improvement in their fiscal accounts due to buoyant commodity prices.

The difficulties indicated suggest the need to expand the fiscal space necessary for pursuing productive development strategies. With inflows of official development assistance (ODA) on the decline and with global demand for these economies' leading exports settling at more moderate levels, the prospects for robust growth in the short term are slim. A period of careful restructuring is needed in order to start to change production and boost corporate efficiency with a view to competing at the regional and international levels.

Source: ECLAC subregional headquarters for the Caribbean, on the basis of official figures and information provided by the World Bank and the International Monetary Fund.

As may be expected, following crises and the sudden drying up of financial flows, the recessionary impact adversely affects fiscal revenues. The larger fiscal deficit in the years following crisis periods is clearly one of the consequences of a crisis, and not one of the causes. What is more, deficits help to moderate the intensity of recessions, as was evident in the global context of 2008-2009. Fiscal policy acted countercyclically in this situation.

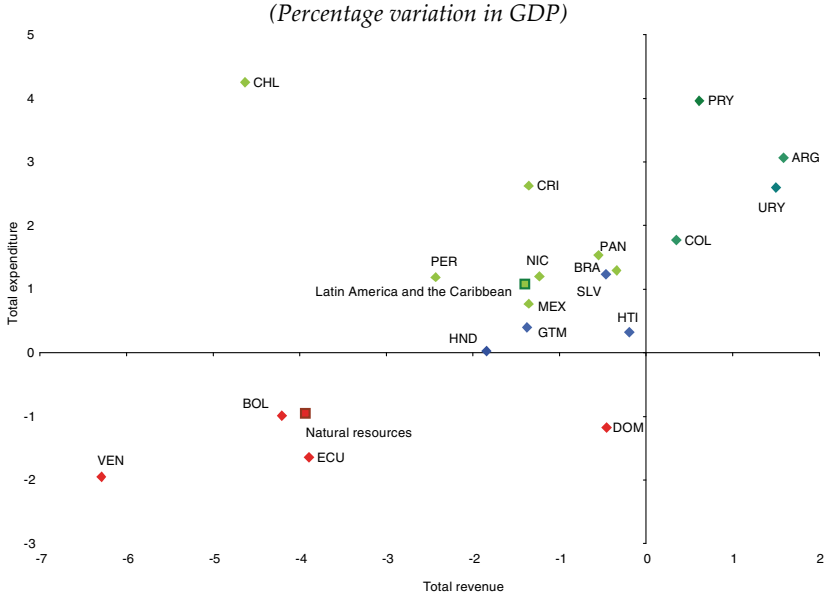
This widespread deterioration in public accounts was the result of differentiated performances in the countries of the region. The upper left quadrant of figure II.6 shows that most countries experienced a fall in their income and increased their expenditure. Only three —Argentina, Colombia and Uruguay— recorded increases in both income and expenditure, while four showed a decline in both categories —Bolivarian Republic of Venezuela, Dominican Republic, Ecuador and the Plurinational State of Bolivia— of which three derive most of their fiscal revenues from natural resources. As was to be expected, in this case, the "empty box" is the quadrant where revenues rise and expenditures fall.

Given the mixed performance of the financial account in the recent era of financial globalization, a distinction must be made between the behaviours and effects of its different components. New foreign investment and long-term loans associated with capital goods imports have been relatively stable during the cycle and are inextricably linked to production investment. The same has often occurred with credits from official regional multilateral agencies, such as the Andean Development Corporation and the Latin American Reserve Fund (FLAR), and from some developed countries; in many cases, these loans compensated partially —with a countercyclical effect— for the absence of private funds during recessions.[7] Conversely, net financial flows have been highly procyclical and, as a result of these very fluctuations, have seldom been used to finance gross fixed capital formation (Uthoff and Titelman, 1998). Indeed, instead of stabilizing the macroeconomy, the region's inward and outward financial flows have destabilized it. Figure II.7 illustrates the external shocks sustained by the region and shows the fluctuations in the terms of trade and capital flows —net of service payments— as well as their relationship with the way in which aggregate demand has evolved.

In a context in which both supply and demand of capital have been managed by private agents, the volatility of capital flows is the fruit of the interaction between different factors, namely: (i) the nature of the local and foreign agents that handle the financial markets —short-termists by training and incentives; and (ii) a process of procyclical adjustment of the domestic economy, encouraged or permitted by the nature of macroeconomic policies. During the boom periods, the euphoria that pushes up asset prices —and fuels bubbles— results in contagion, which in turn stimulates additional flows of funds, since most influential financial brokers are concerned not with the long-term merits of an investment but rather with its returns in the short term. The procyclical behaviour of the risk-rating agencies deepened the disequilibria by influencing agents' expectations. It is remarkable that the very risk-rating agencies which were supposed to safeguard sustainability and keep the evaluation of the agents and markets transparent tended to fuel imbalances with their evaluations. In fact, their assessments continued to have an extremely procyclical slant, just as they did when the Asian crisis was looming (Reisen, 2003).

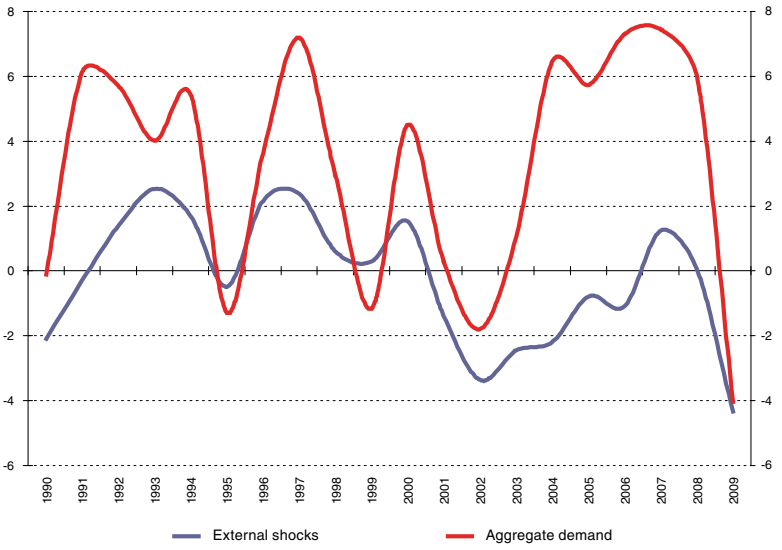
[7] Nevertheless, they have often entailed a procyclical conditionality. Some multilateral financial institutions, such as the International Monetary Fund, have contributed compensatory credits, which play a countercyclical role by easing liquidity restrictions, but they have frequently been subject to the application of procyclical policies, which has delayed the recovery in economic activity and increased social costs (CDP, 2009).

Figure II.6
LATIN AMERICA AND THE CARIBBEAN: FISCAL REVENUES AND EXPENDITURES, 2008-2009
(Percentage variation in GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure II.7
LATIN AMERICA (19 COUNTRIES): EXTERNAL SHOCKS AND GROWTH IN AGGREGATE DEMAND, 1990-2009 [a]
(Annual variation as a percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006.

[a] External shocks are net transfers of resources from abroad plus the terms of trade effect, both measured as percentages of GDP. Net transfers of resources are calculated as net capital flows (including errors and omissions) less net income balance (net factor payments) plus net current transfers, but excluding workers remittances from abroad.

Thus, it is the market itself which provides incentives for emerging economies to venture further into vulnerable territory during boom periods, as it stimulates macroeconomic variables (external liabilities and liquid components, current account deficits, real exchange rates, stock-exchange indices and real-estate prices, among others) to deviate from sustainable levels. The longer and deeper the economy's incursion into this territory, the greater the probability of its entering a crisis and the more serious that crisis will be.

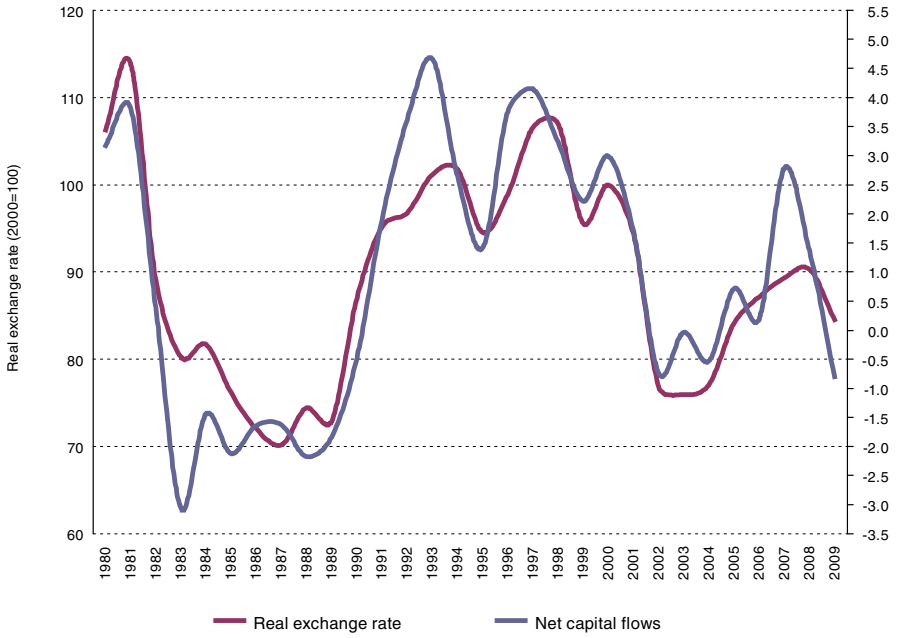
This underscores the need to implement effective regulations to ensure that capital flows boost productive investment and are consistent with a sustainable macroeconomic environment. The composition and volume of financial flows and their deviations from the trend are crucial variables for defining the level and pattern of growth and income distribution, as analysed in the following section.

In addition, in a market economy —the environment in which the region operates— relative prices are among the variables that most influence the decisions of economic agents. Aspiring to achieve an efficient market economy in a developing economy while ignoring such strategic macroeconomic prices as the real exchange rate amounts to a serious contradiction. In the region's experience, the real exchange rate —a fundamental macroeconomic prices when it comes to making decisions relating to production and spending on tradable goods— behaves in an extremely procyclical manner. Its evolution has been strongly correlated with capital flows, which, as already mentioned, are subject to cyclical variations. Figure II.8 shows the marked correlation between the real exchange rate and net capital flows for Latin America in average terms in the years dominated by the Washington Consensus. The procyclical behaviour of these flows is transmitted to the real exchange rate insofar as a boom has often caused sharp currency appreciations, which have repeatedly led to current account disequilibria through over- or undershooting in times of crisis. As shown in section D, this introduces a serious inefficiency through the impact of the real exchange rate on the quality of exports and the production of SMEs geared to the domestic market.

The fluctuations in aggregate demand and its composition and the evolution of the exchange rate have been overdependent on the capital account. The transmission of their procyclical impact to national economies is detrimental to productive development and equity. In order to advance towards sustained development, it is essential to control the transmission of globalized financial volatility. In responsible economies —and the countries of Latin America and the Caribbean have proved to be just that— a completely open capital account, instead of imposing macroeconomic discipline, has been a source of widespread macroeconomic imbalances which have been reproduced throughout the region in recent decades.[8]

[8] See Prasad and others (2003); Singh (2006); and Tytell and Wei (2004).

Figure II.8
LATIN AMERICA (19 COUNTRIES): NET CAPITAL FLOWS AND REAL EXCHANGE RATE, 1980-2009 [a]
(Flows as a percentage of GDP; real exchange rate: index: 2000=100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The net capital flow includes net foreign direct investment, net portfolio investment flows and other investments (including errors and omissions). The exchange rate is defined as the amount of dollars per local currency and is the average for the region (19 countries) weighted by real GDP, that is, an overall increase represents an appreciation in the region's currencies. The data for 2009 are provisional.

D. Effects on growth and equity

One of the fundamental macroeconomic balances is related to the production capacity utilization rate. In economies with imperfect and incomplete markets—as those in the region tend to be—shocks lead to adjustments in prices and in the quantity of goods produced and traded, which add to the effects of the structural heterogeneity characteristic of these economies. Over time, the result is greater disparity between supply and aggregate demand, with the attendant gap between potential production capacity and the actual capacity used, particularly in the stop phases that follow the go phases. In some sectors, demand is paired with full capacity utilization, while in others it is subject to a marked deficiency. In stop-and-go conditions, unstable aggregate demand inevitably gives rise to an average net utilization rate that is lower than production capacity and real productivity that falls short of the production frontier, in comparison with a situation of stable proximity. Of course, greater instability leads to a wider negative output gap and a weaker labour market with higher levels of informality.

The link between real macroeconomic instability and inequality lies in the broad structural heterogeneity that characterizes developing economies. This heterogeneity refers to the varied capacity to act and react of the typical agents in the different markets —for example, large and small entrepreneurs, high- and low-skilled workers, productive investors or investors that

generate GDP, financial investors or asset-buyers, productive investors and consumers— and the asymmetries between their responses to unstable economic activity and macroeconomic prices. In periods of expansion —as opposed to a relatively stable trend— the elimination of liquidity constraints tends to manifest itself more rapidly among consumers than among productive investors, given the weakness of the long-term segments of the capital markets. Similarly, consumers are able to react more quickly than productive investors because investors must identify, design and develop new projects, which is a slow process. Given the irreversibility of investments, in a given moment, long-term investors have to believe that favourable prospects will be sustainable over time, which these agents seem to consider to be an essential condition for making new investments.

After a considerable increase in the level of informality in the 1980s due to the debt crisis, job creation between 1990 and 2002 was centred once more in the low-productivity sectors, which, based on the simple average of 13 countries, increased their participation in urban employment from 47.2% to 50.8% (see chapter V). As emphasized in chapter III, when growth began to accelerate in 2003, this trend reversed and most new jobs were created in the medium- and high-productivity sectors.

Latin America and the Caribbean have experienced volatile business cycles, with sharp and asymmetric contractions and expansions. Inasmuch as the production frontier imposes a limit on the recovery of real GDP, in a recessionary setting, real GDP can remain far below potential GDP for long periods of time. Naturally, real GDP can rise faster than potential GDP, but still remain below it. As long as the gap between the two levels—known as the recessionary gap—persists, so too will the depressive effects on productive investment, the labour market, and the situation of SMEs and the informal sector. Thus, it is important to orient macroeconomic policy to respond to the challenge of establishing greater convergence between the diverse sectors of production and employment, a key topic covered in the next chapter.

Accordingly, real instability is asymmetric and inevitably entails underutilization of productive potential and less real production. In fact, recovery increases the flow of production today to the maximum use of existing capacity, but production that did not occur yesterday cannot be recovered. The size of the gap between real demand and the production frontier has significant static and dynamic effects.

First, it affects the productivity and profitability of projects. Second, higher capital utilization rates tend to mean that the average level of employment is higher and the workforce is paired with a larger stock of physical capital in use. The resulting increase in productivity means that the well-being of the workers and the investors (wages and earnings) can increase immediately, by virtue of the higher average capacity utilization rate. Meanwhile, if wages and earnings rise, so too will fiscal revenues. Thus, workers, entrepreneurs and the government will be able to sustain an increase in consumption and investment, with a net positive impact on general economic well-being. Typically, poverty falls in these situations and income distribution is more likely to improve in the wake of the recovery. The boost to GDP stimulates investment and the growth of potential GDP. Thus, the sign of distributive impact depends on the micro- and meso-economic reforms that accompany the recovery. Growth per se can be progressive or regressive: the former tends to be sustainable and the latter reversible (Bourguignon and Walton, 2007).

With respect to the dynamic effects, the degree of stability has various effects on the construction of the future. The higher utilization rates and the resulting increase in average real

productivity will tend to stimulate investment in new capacity. In order for an increase in investment to materialize, investors must perceive a real improvement in the short term and be confident that the reduction in the recessionary output gap will endure.

The dynamic effect will be much more significant if solid expectations are generated among economic actors in the sense that public policies will maintain real demand near the production frontier and if, in addition, the authorities pursue reforms to complete the long-term capital markets and improve workforce training and productive innovation. Productivity gains are closely tied to greater productive investment in its various forms, given that it entails the introduction of technological improvements (De Long and Summers, 1991).

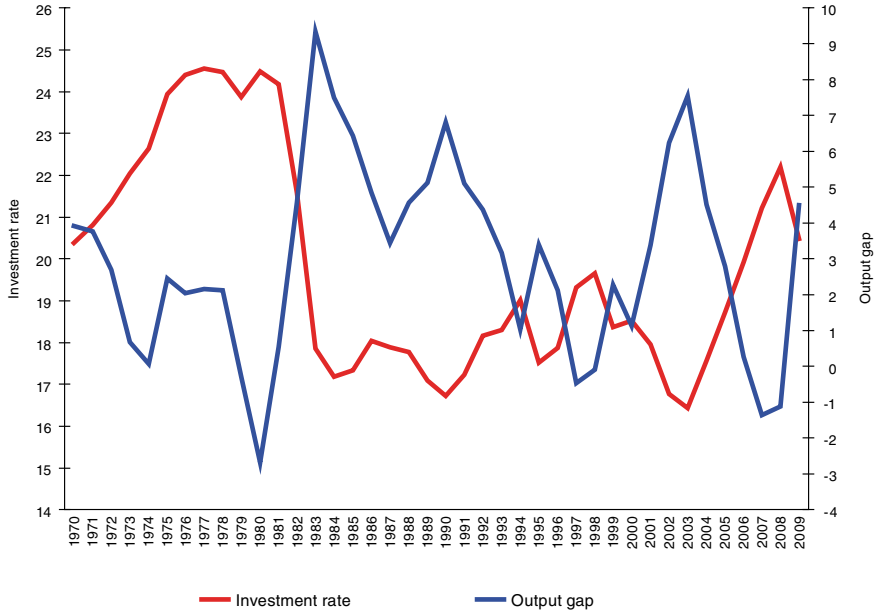
Figure II.9 shows the close association that has existed between the output gap—the recessionary gap—and the fixed capital investment rate in Latin America and the Caribbean; this relationship reflects one of the principal negative dynamic effects: the underutilization of production factors. There are various reasons for this relationship (Ffrench-Davis, 2005, chapter II): (i) where there is considerable idle capacity, there will be fewer incentives to invest in new production facilities; (ii) a volatile environment deters irreversible investment; (iii) underutilization means less earnings and a scarcity of own funds, which also tends to be associated with a reluctance in the capital market to finance firms with lack of liquidity in recessionary situations; (iv) the recessionary gap and its fluctuations tend to diminish the quality of project evaluation and innovation in production, and (v) intense recessionary fluctuations tend to depress public revenue, which leads to cuts in the public investment that rounds out private investment (Easterly and Servén, 2003). Thus, the capital formation rate has fluctuated as a function of the business cycles with much greater intensity than in response to the micro and meso-economic reforms introduced in the region to raise productivity and reduce structural heterogeneity.

Therefore, there is a clear connection between real volatility and long-term economic growth, which affects real total factor productivity, the volume of fixed capital investment, and structural total factor productivity (Ffrench-Davis, 2005).

In short, when conditions are unstable, the GDP level, productivity, the investment rate and employment and its degree of formality —all adversely affected by the recessionary gap— will be lower than in a context of greater real macroeconomic stability.

As regards the exchange rate, instability in the real exchange rate, associated with financial capital flows, has been detrimental to the performance of exports, their diversification and their degree of integration into the national economies (Agosin, 2007). Such widely fluctuating rates do not reflect changes in the levels of equilibrium, since these respond to changes in relative productivity levels between the countries of Latin America and the Caribbean and their trading partners, and to a level of net capital inflows in sustainable and efficiently absorbable volumes. These structural variables tend to experience gradual, not sudden, changes. Therefore, the fluctuations in the real exchange rate of many countries have generally reflected mismatches caused by volatile capital flows that distort project evaluations used for allocating resources, encourage speculative investment over productive investment, artificially relocate the domestic production of importable goods (many of which are produced by SMEs), discourage value-adding to traditional exports and help incentivize dollarization.

Figure II.9
LATIN AMERICA (19 COUNTRIES): OUTPUT GAP AND GROSS INVESTMENT RATE, 1970-2009 [a]
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures, R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and A. Hofman and H. Tapia, "Potential output in Latin America: a standard approach for the 1950-2002 period", *Estudios estadísticos y prospectivos series*, No. 25 (LC/L.2042-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), December 2003. United Nations publication, Sales No. E.03.II.G.205.

[a] Includes Argentina, the Bolivarian Republic of Venezuela , Brazil, Chile, Colombia, Costa Rica, Mexico, Peru, and the Plurinational State of Bolivia. The investment rate measures the ratio between gross fixed capital formation and actual GDP, while the output gap measures the difference between real GDP and potential GDP as a percentage of the latter.

Naturally, cyclical fluctuations in the real exchange rate act as a disincentive to acquiring new comparative advantages and adding value to traditional commodity exports. This failure of the exchange-rate policy places a heavy burden on a development strategy driven by exports, especially non-traditional exports and exports with high value added. If exports are not integrated into the national economy, do not transmit externalities, do not have value added and are produced with no input from SMEs, how can they become an efficient engine of economic growth? Managing exchange-rate policy is a key component of the variables required for that to happen (Rodrik, 2008; Williamson, 2000).[9]

In addition, due to the exchange-rate appreciation, especially after the significant liberalization of imports in the region (ECLAC, 1998a, chapter V), in each of the boom periods, the recovery of aggregate demand—both on the part of individuals and firms—became increasingly

[9] One effect that has at times tempted the authorities and analysts to defend and promote exchange-rate devaluations has been their downward impact on the prices of tradable goods. In several cases, success in lowering inflation has been associated with destabilizing revaluations of the exchange rate in an exchange-rate anchor regime. In fact, the vast majority of countries in Latin America revalued their currencies in real terms between 1990 and 1994, between 1995 and 1997, and in the boom period that began in late 2003. Access to external financing spurred the successive real revaluations.

import-intensive. Along with the positive increase in imports of capital goods, sharp increases in other imports have occurred, many of which competed with the savings rate and production by local SMEs. As a result, not only the level but also the quality of exports was affected. Thus, appreciation has a pronounced procyclical effect on the external sector and causes internal reverberations in the productive sectors that compete with imports.

Instability also tends to be asymmetric in terms of distribution because the sectors with higher income and access to markets take better advantage of the opportunities that arise during periods of expansion. Also, these sectors adjust more rapidly in periods of contraction, which leads to a widening of the gap between large companies and SMEs and an expansion of the informal sectors during recessions. The available data indicate that income distribution tends to deteriorate in recessions and to improve—although less significantly—in times of recovery.[10] The labour market is adversely affected because instability has a disincentivizing effect on investment and less-skilled workers are often discriminated against in times of rising unemployment. As noted, instability tends to increase the level of informality in the labour market. The more incomplete the financial markets and the lower the capital formation rate, the greater the likelihood that regressive effects will predominate.

The regressive impact on the labour market is also associated with the sectors most affected by cyclical adjustments. Table II.2 shows that most of the adjustment in GDP growth observed in 1990-1997 and 1998-2003 may be attributed to production for the domestic market, i.e., non-export GDP.[11] This reflects two facts, one at the microeconomic level and the other at the macroeconomic level. The first shows how difficult it is to reallocate resources from the production of non-tradable goods to exportable goods and import substitutes. In this regard, reallocation policies have been weakened by liberalization processes in the region's countries and institutional changes in international trade (Rodrik, 2001). As a result, the available instrument —the exchange rate— assumes considerable and greater importance. Declining to regulate it, i.e., allowing it to float without any intervention from the economic authority, is profoundly contradictory to an export-driven development strategy.[12]

The second point is macroeconomic in scope. Table II.2 shows that nearly 95% of the decline in GDP between the two periods of comparison occurred in the domestic economy.[13] As this depends on the local macroeconomy and exports depend more on the global macroeconomy, the data indicate that real instability has been more strongly localized in the domestic markets. In the countries of Latin America and the Caribbean, this relationship depends crucially on the quality of macroeconomic policy. The way in which it has been managed has been very procyclical and has exacerbated, instead of mitigating, the transmission of external trade and financial shocks.

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[10] For example, with the debt crisis, it took 14 years for per capita GDP to recover to pre-crisis levels (1980-1994), and 25 years—from 1980 to 2005—for the poverty rate to return to the original level (ECLAC, 2009c).

[11] As exports grew, so too did the share of gross exports in GDP, from 12% in 1990 to 23% in 2008 (from approximately 11% to 18% taking into account exports net of their imported content. Evidently, although the share of non-export production has been declining appreciably, it still accounts for most of GDP.

[12] In the region, there are economies that are strongly export-driven, such as Chile's. However, this is not the case in Brazil, where the relative weight of the domestic market is very strong.

[13] In order to achieve robust growth, non-export GDP must also undergo a rapid expansion. This is what happened in the emerging economies that had a successful export-driven productive development model, such as the Republic of Korea's, over several decades, and Chile's from 1990 to 1998, when annual non-export GDP growth was around 6.5%. Conversely, in Latin America, annual non-export GDP growth was just 2.7% in the period 1990-2008 (see table II.2).

Table II.2
LATIN AMERICA (19 COUNTRIES) AND THE WORLD: ANNUAL VARIATION IN GDP, EXPORTS AND NON-EXPORT GDP, 1990-2008
(Percentages)

	Latin America (19 countries)			World	
	GDP	Exports	Non-export GDP	GDP	Exports
1990-1997	3.3	8.3	2.7	2.9	6.2
		(0.9)[a]	(2.4)		
1998-2003	1.4	5.1	0.8	3.3	4.9
		(0.7)	(0.7)		
2004-2008	5.3	7.1	5.0	4.5	6.5
		(0.8)	(4.5)		
1990-2008	3.2	6.9	2.7	3.4	5.9
		(0.8)	(2.4)		

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and data from the International Monetary Fund (IMF) and the World Trade Organization (WTO).

[a] The figures in parentheses denote the contributions to total growth of the economy of exports and non-export GDP, respectively. The value added of exports was estimated as gross exports of goods and services minus their imported content, which was considered equivalent to the share of imported and intermediate capital goods in total GDP. In the case of Mexico's maquila industry, real value added data were used.

A premature, indiscriminate and poorly sequenced liberalization of the capital account and the national financial markets has become a source of costly destabilizing shocks. As documented, the high costs created by the economic cycles in the countries of Latin America and the Caribbean are related to the close ties between the domestic financial markets and the procyclical segments of the global financial markets. At the same time, the more the flows fluctuate, the less likely they are to be allocated to finance capital formation (Uthoff and Titelman, 1998), and indeed, given the extent to which they have fluctuated, only a very small percentage of the flows was used to finance productive investments.

As liberalization has been pursued, financial savings have spiked without an increase in domestic savings, with a very low rate of gross fixed capital formation and intense volatility in the economy and employment (see section 4 of chapter IV). The main cause is a financial market dominated by agents specialized in the short term and not in productive investment. The financial agents with the greatest influence on cyclical fluctuations, which are not closely tied to productive investment, have played a key macroeconomic role. This weakness is exacerbated by the fact that their volatility has led to financial and exchange-rate crises, whose recessionary effects have discouraged the formation of domestic capital and employment.

E. The challenges of a macroeconomy for development

The objectives of comprehensive stability—including the level of prices, macroeconomic prices and aggregate demand consistent with potential GDP—are a prerequisite for locking in progress, correcting failures and accelerating progress towards development. As demonstrated, these are effective signs necessary for achieving economic growth, they play a role in combating poverty and they facilitate efforts to achieve sustainable equity.

The lack of overall stability has been closely tied to capital flows and their volatility. Volatile procyclical flows are part of the external funds that comprise the external savings needed, in addition to domestic savings, to finance a substantial increase in the investment rate. Accordingly, there is no valid "all or nothing" option. Consequently, a fundamental objective of macroeconomic policies and national financial market reforms should be to take advantage of the potential benefits of external savings for national productive development. These benefits should be utilized, above all, to supplement domestic savings, while reducing the intensity of financial-account cycles and their negative effects on domestic economic and social variables.

It is essential to formulate a coherent set of countercyclical fiscal, monetary, exchange-rate, domestic financial market and financial-account policies, accompanied by an effort to establish robust long-term segments and a stronger development banking system to complement capital markets.

1. Countercyclical fiscal policy

The global financial crisis has pointed up the central importance of fiscal policy as a tool for macroeconomic stabilization. Most industrialized countries have attempted to contain the crisis by means of a monetary policy with near-zero interest rates and comprehensive fiscal stimulus packages (Freedman and others, 2009) which combine infrastructure spending increases and specific measures to fight unemployment and lower taxes.

In 2009, most countries experienced severe recessions, which they tried to counteract with high fiscal deficits —generated by automatic stabilizers— or discretionary packages.[14] The few countries with positive growth rates —notably China, Egypt, India and Pakistan— also had high fiscal imbalances. As a result, the recent global crisis has led to a growing consensus on the importance of automatic stabilizers and the intensive use of budgetary instruments. The use of temporary fiscal deficits in periods of steep decline in private demand has been legitimized as an indispensable macroeconomic stabilization tool (Krugman, 2009).

However, once the emergency has ended, the post-crisis exit strategies should include, inter alia, fiscal responsibility and public debt sustainability targets consistent with the public investment and social policies required to accelerate progress towards sustainable development. Understood as such, fiscal responsibility is vulnerable to economic and social trends, national contingencies relating to governance and political commitments. In order to maintain solvency over the medium term, reaffirm the credibility of fiscal policy and prevent a pernicious trend towards excessive discretion, many analysts propose various alternatives, such as establishing numerical rules and creating independent fiscal councils.

Recent experience demonstrates that it is not possible to formulate rigid rules independent of the business cycle. Under normal circumstances, ECLAC (1998b) has recommended, as a guiding principle of fiscal policy, the use of a structural indicator of the public balance instead of the real balance. The creation of funds aimed at stabilizing fiscal revenue from exports, whose prices are characterized by instability, is part of an approach of this nature. In fact, a considerable

[14] The importance of automatic stabilizers depends on many factors, such as the weight of the public sector in the economy, the progressiveness of the tax system, the mechanisms for public employment and unemployment subsidies, and the sensitivity of unemployment and tax evasion to variations in GDP. These structural characteristics vary considerably by country and over time.

percentage of fiscal receipts comes from income associated with commodity exports, such as copper, oil, gas, sugar, coffee and soybeans. In order to moderate the elevated volatility that this reliance imposes on public finances, several countries have created stabilization funds. It should be noted that when well run, these funds are able to help stabilize normal fiscal expenditures, contribute financing in crisis situations such as the present one and stabilize the foreign exchange market by regulating the supply of foreign currency. For this, full coordination between the fiscal authority and the exchange-rate authority, which tend to reside with different institutions, is essential. Inadequate coordination can impede the alignment of the macroeconomic environment with sustained development, leading to an imbalance between diverse objectives, e.g., inflation, employment, export quality and growth.

Experience has shown that there are exceptional circumstances that warrant more active and discretionary policies. Any macro-fiscal rule should have the objective of achieving structural or public debt balance in the medium term—including the subnational governments—and exception and provisional clauses when there are significant macroeconomic fluctuations. Although fiscal rules are not a panacea that guarantees credibility and fiscal solvency, if enough flexibility is built in, they can become a powerful countercyclical tool.

Mechanisms must be developed at the level of the legislature, specialized agencies and citizen organizations to institutionalize countercyclical fiscal policies as a counterweight to potential fiscal discretionary excesses during boom periods. Optimal fiscal balance and public debt levels are not constant. Fiscal sustainability—measured, for example, as the stability over time of the ratio of public debt to GDP—depends on the differential between the rate of economic growth and the real interest rate at which the public sector borrows. For example, if the interest rate rises and growth is slow, the sustainability of fiscal policy is immediately impaired. As a result, the optimal public debt level will depend on the pace of growth and financing terms and conditions, which are largely subject to the credibility of domestic policies and progress in creating a new international financial architecture which will give low- and middle-income countries access to stable financing without recessive conditions.

It is also important to set a public debt target in the medium term, especially in the countries of Latin America and the Caribbean, which have enormous infrastructure gaps and urgent needs for greater physical and human capital. In recent decades, fiscal adjustments have severely dampened public investment, so establishing mechanisms to stimulate gross fixed capital formation in public goods will be key. One alternative is to keep separate budgets for current expenditures and investments, since in accrual basis accounting, investments are not a liability but rather an asset. Clearly, forging an economy based on infrastructure investment and productive development requires avoiding the traditional bias against public investment in the general government budgets.[15]

In any case, in Latin America and the Caribbean, the social evaluation of projects must be improved and national public investment systems must be strengthened institutionally. This is a key factor in promoting greater public investment, enhancing its complementarity with the private sector, raising productivity, and helping to improve the quality of the labour environment.

[15] See the case of Latin America in Blanchard and Giavazzi (2004), Easterly and Servén (2003), Martner and Tromben (2005) and Lucioni (2004).

In a context of tight borrowing constraints, the public sector's social spending capacity must be maintained or strengthened. In Latin America and the Caribbean, the countercyclical strategy should focus on investments to support employment and on mitigation of the social costs of the crisis. From an equitable growth perspective, programme design must include an analysis of the programme's contribution to the acceleration of productive development and to the employability of the labour force in decent work.[16] The events that have taken place in the region clearly show that economic figures recover more rapidly than poverty and inequality indicators.

Significant and sustainable improvements in poverty reduction and income distribution in Latin America and the Caribbean will not be made without active fiscal policies that boost the quality and distributive potential of the markets. The transitory coexistence of budgetary imbalances and macroeconomic stabilization is part of a medium-term strategy keyed to the performance of social indicators and productive development and which in its decisions assigns greater weight to the targets related to structural balance than to the actual public balance.

Lastly, it is not only the composition of expenditure, but also its level and financing that is a key factor in the distribution of income and opportunities throughout society. Accordingly, there can be no further delay in establishing fiscal covenants that identify the magnitude of society's contribution to the financing of public policies and that determine how it will be collected, whether for investment or social expenditure (see chapter VII). In most countries in Latin America, it is clear that the present tax burden is insufficient and the tax structure is inadequate for modernizing the productive structures and achieving greater social equality. In this regard, there is no single formula that will work for every country. In a few countries, it may be that the tax burden should be raised, whether through new taxes or more efficient collection and a more decisive effort to combat tax evasion. In others, the priority may be to improve the quality of expenditure, both in terms of allocation and efficacy, with the goal of chipping away at the inequality of social and economic structures.

Strengthening the countercyclical role of fiscal policy is necessary, but it is not enough, given that fiscal expenditure in the region's countries is a small fraction of aggregate demand. Therefore, little progress will be made if the other policies depend on volatile flows and the opinions of procyclical agents. It is absolutely critical to ensure coordination of the various macroeconomic policies —fiscal, monetary, exchange-rate, and financial account policies— which will be addressed in the following sections.

2. Monetary policy

Domestic macroeconomic policies should attempt to create an environment of reduced real volatility, sustainable external and fiscal accounts and stable prices. This task is complex, since national authorities lost considerable latitude as a result of the liberalizing reforms of recent decades. So, although much fewer of the imbalances were of fiscal origin, the transmission to the national markets of externally generated cycles, especially those caused by the global financial markets, has been exacerbated.

[16] This concept was originally coined in the *Report of the Director-General: Decent Work*, at the eighty-seventh session of the International Labour Conference, held by the International Labour Organization (ILO) in 1999, in which decent work is defined as productive work in conditions of freedom, equity, security and human dignity, in which rights are protected and which generates an adequate income and adequate social protection. This definition subsequently incorporated the promotion of social dialogue and later came to address job quality.

In order to create more leeway for monetary policy and implement it in conjunction with exchange-rate policy, the capital account should be regulated. The principal variables of monetary policy are the interest rate and liquidity regulation. Experiences with financial liberalization have demonstrated that liberalized interest rates tend to be unstable and much higher than international rates, with much wider spreads over long periods of time (ECLAC, 1998a, chapter IX; Ffrench-Davis, 2008a, chapter IV; Stallings and Studart, 2005). From a macroeconomic sustainability perspective, it is significant that the spreads have been procyclical. The actual fact is that productive investments have been subject to considerable macroeconomic instability, with wide recessionary gaps in a very incomplete market, where investors have faced high, unstable average interest rates, particularly in the case of small firms.17 This had the effect of dampening investment and weakening employment and equity.

In Latin America, monetary policy has increasingly adopted inflation targets, that is, a single anchor approach where the explicit announcement of an inflation target is the monetary anchor of the economy. In general, this trend has been accompanied by freely floating exchange-rate regimes and financial-account deregulation. This new mix of policies imposes significant limitations on, or obstacles to, the countercyclical policies of the economic authorities.

In small open economies, such as those of most countries in Latin America and the Caribbean, the inflation targeting system has highly procyclical features for the real economy, especially in comparison with global financial markets. Given the important role of capital flows in driving the business cycles of emerging economies, the break points in periods of prosperity tend to be characterized by strong expectations of depreciation and a downward trend in aggregate demand and output, followed by expectations of appreciation and recovery after touching bottom in the lower part of the cycle.

Given that in more open economies the exchange rate has a stronger impact on the consumer price index (CPI), an economic environment marked by expectations of exchange-rate depreciation or appreciation is also characterized by expectations of deflationary or inflationary pressures. As a result, the incentives of a central bank with a policy focused exclusively or excessively on inflation will be biased towards implementing excessively contractionary monetary policies just when the economy is beginning to experience the downward part of the cycle, once excess aggregate demand has subsided, but with inflationary pressures stemming from exchange-rate devaluations. This drives the monetary authorities to intervene in the exchange-rate market to attain the inflation target, as described in the next section. In contrast, at the other end of the cycle and from the viewpoint of inflation targets, the bias tends to be toward applying expansionary monetary policies so that the recovery is led by capital inflows. The resulting exchange-rate appreciation trend, driven by capital inflows, acts as an artificial brake on increases in the CPI. The data, which show that the economies have functioned chiefly below the production frontier, seem to indicate that the recessionary bias has been stronger than the expansionary bias, inasmuch as the prevailing trend is real exchange-rate appreciation.

In a context of asymmetries in capacity utilization, the procyclical trend assumes average real GDP far below average potential GDP. Thus, a first challenge in the implementation of monetary policy based on inflation targets should be to eliminate this procyclical bias. There are a number of possible solutions for dealing with this problem. One is to use price indices of

[17] Some central bank data indicate that the high averages mask significant differences between the costs paid to the formal financial sector by large companies and by small firms, most of which do not even have access to the formal market.

non-tradable goods instead of the general price index to set the inflation target (Parrado and Velasco, 2002) and take into account the movement of asset prices and potential bubbles in those markets. Another option is to set the target based on a long-term horizon to filter the transitory effects of the exchange rate and their impact on the general price index.

Even more importantly, the full complement of objectives of any macroeconomic policy oriented towards economic growth and equity should be considered. Other proposed solutions include setting targets on external deficits as a way to mitigate the transmission of volatility from capital flows to domestic output (Marfán, 2005). Another option is to implement or strengthen targets in the real sector, such as those designed to reduce unemployment or make real GDP consistent with potential GDP.

A key point is the weight or relative importance of each variable in the central bank's response capacity and coordination with the rest of the economic authorities. It is important to recall that recent years have been characterized by low or moderate inflation in both developed countries and emerging economies. Against this backdrop, the additional effort required to bring down already low inflation tends to involve diminishing returns and rising costs. A central bank with considerable autonomy from the national political and economic authorities and clear anti-inflation preferences makes the target more credible in the preliminary stages of the fight against inflation, in the wake of high prices. However, in a region that has generally held annual rates in the single digits, and particularly in countries that have managed to keep inflation low and stationary, the excessive autonomy of the central banks and inattention to other macroeconomic goals have lost the validity acquired during times of fiscal irresponsibility and high inflation. Excesses tend to be inefficient, including the replacement of one excess by another. The mediocre result seen in growth and equity has its correlation in the imbalances between targets and coordination failures.

In a context of moderate inflation, more complex mechanisms must be designed that enable the central banks to respond and make a moderate and relatively stable inflation rate compatible with a GDP growth rate that is sustainable and consistent with the expansion of potential capacity and aggregate demand. The purpose of a stable, low inflation rate is to improve market information, incentivize innovation and value adding and spur investments and their degree of efficiency. This leads to more dynamic growth with a positive impact on equity. In contrast, an imbalance in the objectives is detrimental to development.

However, even if the more modal approach is resumed and an attempt is made to eliminate the procyclical bias of inflation targets by adopting a series of objectives —that is, a multi-anchor approach— a second problem may arise: a monetary policy with limited effectiveness, whether because it acts as a drag on domestic demand, produces insufficient results or has offsetting effects on other macroeconomic variables, such as the exchange rate.

During an expansionary phase, if monetary policy is managed to regulate aggregate demand by raising interest rates, local agents will turn to more external financing and short-term external funds will be attracted by a higher differential between the international interest rate and the domestic interest rate, an incentive that can be further accentuated by expectations of exchange-rate appreciation. In this context, higher interest rates tend to coexist with a tradable goods sector adversely affected by exchange-rate appreciation and with an increase in aggregate demand and the production of non-tradable goods financed by external savings—which tend to

displace domestic savings. The policy failure becomes evident and costly when output nears a slow moving production frontier.

The capacity of monetary policy to absorb shocks during the contractionary phase is more restricted, especially if the economy has already entered vulnerability territory. The textbook says that, given a specific external rate, a drop in the domestic interest rate will lead to capital outflows, causing the exchange rate to depreciate. Depreciation, in turn, will tend to favour recovery of the production of tradable goods and stimulate GDP growth. However, in practice, the negative effects of depreciation on consumption and short-term balances are usually stronger than the positive impact on the production of these goods. In contrast, if monetary policy is used to try to halt capital flight, the interest rate can be used to restrict aggregate demand —thus exacerbating a recession— but may be useless with respect to the capital outflows if there are strong expectations of depreciation and contagion of pessimism.

In summary, the effectiveness of countercyclical monetary policy in an open financial account and freely floating exchange rate context is much more limited than assumed in the standard theories. Consequently, the main policy implication of our analysis is that it is crucial to regulate capital flows to make room simultaneously for complementary countercyclical exchange-rate and monetary policies. It is dangerous and very naive to think that an excessive flow of capital meant only to generate income will never again appear, especially given the financial nature of the current global crisis.

3. Exchange-rate policy, productive development and sustainable stability

The exchange rate is a key macroeconomic variable for the sustainability of macroeconomic balances and the allocation of resources. Naturally, the relevant macroeconomic price refers to the basket of exchange and inflation rates of a country's trading partners, which vary according to the trade structures of the different countries.[18] The conventional approach, which maintains that the only exchange-rate option is a fixed nominal rate or a fully flexible rate, presupposes that the market will benignly set a sustainable equilibrium real exchange rate. This implicitly means levels and movements that involve a correct price for allocating resources among tradable and non-tradable goods and for attracting additional physical capital resources and labour. Aside from an effective allocation of existing resources, economic growth is chiefly characterized by a vigorous expansion of the stock of factors and their productivity.

The present modal exchange-rate policy supports a freely floating exchange rate. Several countries in Latin America and the Caribbean adopted freely floating exchange-rate regimes after the contagion of the Asian crisis in 1998. The problem caused by the new regime was that the exchange rate became extremely sensitive to temporary adjustments in the supply of external funds, accompanied by an inefficient allocation of resources. In times of scarcity of funds, the real exchange rate reflects a strong devaluation, as can be seen in figure II.8, but in the present context of recession and liquidity constraints, producers have a hard time taking full advantage of the rate incentive. In the next stage, when external constraints disappear thanks to a greater supply of external funds, new revaluations soon occur. In this regard, another asymmetry should be noted:

[18] ECLAC periodically calculates the real exchange rate of each country in the region, taking into account matrixes of nominal exchange rate and price level ratios, weighted by the relative contribution of the various trading partners. In contrast to the trade-weighted real exchange rate —relevant in the world of production— the real exchange rate relevant for financial flows tends to refer exclusively or predominantly to the dollar.

during periods of expansion, the financial markets are willing to finance larger investments, but exchange-rate appreciation discourages capital formation in the production of tradable goods. As a result of this procyclical behaviour of the real exchange rate, the business cycle shows a bias against tradable goods. Paradoxically, import liberalization reforms sought to position tradable goods centre stage, on the assumption that the exchange rate would come to play a key role in international competitiveness. However, the two exchange-rate options offered by the Washington Consensus—which are extremes—counteract that objective.

There has been a growing body of literature which discusses the nexus between exchange-rate policy and development in recent years. In addition to the invaluable studies of John Williamson, particularly his 2000 paper on intermediate regimes and the financial account, Rodrik (2008) discussed the impact of the real exchange rate on the production impulses supported by a depreciated real exchange rate. Eichengreen (2008) also looks at this topic, but emphasizes the need to limit the extension of periods of exchange-rate incentives. Meanwhile, Agosin (2007) analyses the issue of the quality, value-added and externalities of exports and compares the experiences of the Latin American and Caribbean countries with those of the Asian economies.

The aforementioned failures of the modal exchange-rate regimes regarding the distributive role of the real exchange rate also have implications for macroeconomic balances, as presented in the section on monetary policy. The boom and bust cycles of the global financial markets generate demand for flexible macroeconomic variables that are able to offset or absorb positive and negative impacts in the short term. Given the limited effectiveness of some traditional policy instruments, mainly the monetary policy implemented in response to the financial shocks, the exchange rate can play a central role in buffering the after-effects. In fact, the freely floating exchange-rate option, which eliminates the monetary effects of foreign exchange operations and restores equilibrium to the balance of payments on a sustainable basis, is key to making room for monetary policy. However, this objective is usually contradictory to the trade-related goals of exchange-rate policy, inasmuch as it tends to throw the current account out of balance.

Intermediate regimes of managed exchange-rate flexibility—such as crawling pegs and different types of moving bands or dirty floating—are a serious pragmatic attempt to reconcile these competing demands (Williamson, 2000). The typical neoliberal position is that any exchange-rate intervention is tantamount to going against the market and is destined to fail. On the contrary, the point is that real market forces—importers and producers of exportable and importable goods, which are important in terms of productive development and equity, should take the lead in determining the exchange rate. This is the market that should gain ground, not the market of the short-term operators.

Currency board regimes certainly build in automatic institutional systems for imposing fiscal and monetary discipline but they reduce manoeuvring room for monetary and exchange-rate stabilization policies, which are needed both to prevent crises and to stimulate post-crisis recovery. Currency boards facilitate the domestic transmission of destabilizing shocks originating in the global capital markets and cause wide swings in economic activity and asset prices, leading to costly domestic financial vulnerability.

The volatility characteristic of freely floating exchange-rate regimes is not a serious problem when fluctuations in the financial and commodity markets are short-lived, because they are resolved with the derivatives markets—if they exist in the local market—or they quickly even out

given the continuous reversibility of fluctuations. However, it is a significant problem in terms of the allocation of resources when the waves last for several years, such as those that have characterized the access of emerging economies to capital markets in recent decades. In such cases, sharp fluctuations in the real exchange rate tend to generate misinformation about the equilibrium exchange rate, with adverse effects on the allocation of resources.

Exchange-rate fluctuations caused by the cyclical movements of financial capital are exacerbated when countercyclical monetary or credit policies are adopted under freely floating exchange-rate regimes and open financial accounts. As explained in the section on monetary policy, this results in the classic problem in which a countercyclical monetary policy causes procyclical fluctuations in the exchange rate. For example, this happens when the monetary policy seeks to contain domestic demand by raising the interest rate, attracting financial capital and causing the real exchange rate to appreciate. The capital inflows boost demand, but exchange-rate appreciation halts inflation and introduces an expenditure bias towards imports.

Thus, the ability of a flexible exchange-rate regime to smooth out the effects of externally induced boom and bust cycles depends on the capacity to effectively implement a countercyclical monetary policy without encouraging procyclical exchange-rate movements. This is possible only systematically under actively managed intermediate exchange-rate regimes combined with some of the various types of countercyclical prudential regulation, which can be applied to the financial account as explained in section 4. These intermediate regimes with managed flexibility represent the best possible option for addressing the two demands that exchange-rate policy must meet.

Intermediate regimes with actively managed flexibility can entail costs and restrictions. First, these regimes will be subject to speculative pressures if they do not have the confidence of the respective market, so the cost of defending the exchange rate is very high. In critical moments, such as when there is a loss of confidence, it can be advisable to move, for a period of time, to full flexibility. Second, the accumulation of sterilized reserves during periods of expansion tends to involve financial costs. Therefore, countercyclical regulations on flows lower these costs by reducing excess inflows. Lastly, regulation of the financial account—necessary for effectively managing intermediate exchange-rate regimes—tends to experience rising losses that must be dealt with through ongoing monitoring of sources. However, if a countercyclical prudential approach is not adopted, the result will be severe volatility with high social and economic costs.

In summary, exchange-rate policy must be radically corrected so that it aligns with a development strategy that gives a central role to exports. That would also help bring about systemic competitiveness, that is, develop productive capacity not only for the external markets but also for the domestic market, where the vast majority of workers and firms are located. As will be discussed in the next chapter, greater systemic competitiveness helps to close output gaps with more developed countries and reduce internal structural heterogeneity, creating more egalitarian conditions in the labour and business market.

4. Capital market reform

As this chapter has shown, capital markets have major repercussions on macroeconomic balances and powerfully influence other variables that are critical for capital formation and the distribution of opportunities and income among economic stakeholders. This is associated with two particular features of this region's developing economies. First, capital markets are incomplete, with certain

segments either weak or lacking. To a greater or lesser degree, this problem can be found in every country of Latin America and the Caribbean. Second, the impact of this shortcoming in the region is exacerbated by the extreme structural heterogeneity among economic agents. Close ties with the most volatile international financial markets in recent decades also explain in part the shortage of productive investment and the precarious nature of labour markets.

This section will examine the direction that reforms of the national capital market need to take if they are to contribute effectively to the development of production. The discussion will then focus on reforms for managing the capital account with other countries so as to tap its potential to contribute to national development more fully while minimizing the economic and social costs involved.

(a) Domestic markets and development financing

The 1980s and 1990s saw widespread reforms on domestic capital markets. This was triggered by unsatisfactory earlier experiences in previous decades with increasingly interventionist policies and highly distorted real interest rates, which in countries with high inflation were frequently tantamount to negative real rates. Very often, reform meant the liberalization of interest rates, transaction terms and credit allocation and the relaxation of regulations and prudential oversight of financial institutions.

Reformers expected impressive growth in national savings and to achieve equilibrium interest rates that would result in a more efficient allocation of funds into investment in the most productive sectors. In terms of savings volumes, the overall impact was a significant increase in financial savings in the short-term segment of the capital market. Parallel to this increase, however, development banking has tended to weaken and the long-term segment to lose momentum, without there being an increase in domestic savings or productive investment (see figure II.4).[19] Clearly, the contrast between the rise in financial savings and the stagnation of domestic savings meant that the reform channeled savings into consumption and the purchase of already existing assets instead of encouraging capital formation.[20]

Nor did interest rates respond in such a way as to ensure growth or equality. Interest rates are a highly significant variable both for resource allocation and at the macroeconomic level. When domestic rates were liberalized in the countries of the region, they frequently proved to be unstable and far higher than international rates, with much greater and longer-lasting spreads. This has meant that systems with high financial costs and segmented markets continue to be the rule.[21] In short, investors in production activities have been faced with a real economy that is

[19] For the most part, capital markets have remained underdeveloped, with nearly 70% of financial resources still being channeled through the banking system. The rest is characterized by stunted capitalization rates, too few shares being traded, minimal new stock issues on the markets and highly concentrated transactions with few shares.

[20] Over the last two decades, gross domestic savings in Latin America hovered around 20% of GDP, significantly less than in other developing regions, such as southern Asia and the Pacific (40%) or the Middle East and northern Africa (30%).

[21] For example, the book value of general bank expenditures in 2007, expressed as a share of total assets, exceeded 5% in Latin America, more than in Southeast Asia (2%), the Middle East and northern Africa (2.3%) and Asia and the Pacific (3%). Significantly, Chile applied similar reforms in the 1970s and obtained similar results: from 1973 until the 1981 peak, prior to the 1982 recession, average annual GDP growth of barely 2.9%; from 1975 to 1982, active interest rates that were too high, averaging 38% annually in real terms; low rates of capital formation, deteriorating conditions for labour and income distribution, and finally in 1982 and 1983, a severe banking and exchange-rate crisis (Ffrench-Davis, 2008a, chapters IV and V).

clearly unstable in a very incomplete financial market and were hit with extremely high average interest rates, especially for holders of non-preferential debt.[22]

With the onset of the current global downturn, the financial institutions of the region's countries have displayed considerable progress inasmuch as they have successfully managed to avert banking crises. They are also now on a more solid footing, less exposed to risk and covered by stricter oversight, but they have clearly failed to provide broader financing to current economic activities. An overview of financial system reforms shows that these institutions have not developed enough to tackle structural heterogeneity or provide financing for the production sector. A proactive relationship among financial institutions still needs to be forged, and the degree of heterogeneity needs to be lessened for them to have a more inclusive effect on society (see the following section and chapter III). Still pending is the implementation of the Monterrey Consensus of the International Conference on Financing for Development which would boost the resources for financing economic, social and environmental development in the region and design them to be countercyclical.

The reorganization of the financial system must therefore aim to channel resources into savings and investment, which calls for a more fully developed capital market rather than reforms that focus on the short term. The countries need institutions able to serve a vigorous long-term segment so that savings are funneled into financing for productive investment, along with prudential and countercyclical regulations. Similarly, institutions should grant public and private development banks an active role in the process as this is the best way to guarantee the vitality of the long-term segment.

The handling of institutional savings, such as pension funds, merits high-priority attention to ensure that these long-term funds are channeled into productive development in the domestic economy (see the following section). This is critical to guarantee sustainable welfare for savers given their dual status as both workers and future retirees.

(b) Toward more equitable access to financing

When access to financing is heterogeneous, inequalities in production capacity become more marked and the ability to enter large markets turns more segmented. This creates a vicious cycle that condemns lower-capital sectors and production units to a permanent state of vulnerability and feeble growth. Unequal access to financing and unequal conditions of financing are a centrepiece in perpetuating social inequality.

Above all, small-and medium-sized enterprises and low-and middle-income sectors need greater access, as these groups generally feel the impact of social segmentation in the capital market. This is important, not necessarily because SMEs are leading the pack at the technological forefront, but because they have an enormous impact on social inclusion, on buffering structural heterogeneity and, accordingly, on bringing about greater social equality (see chapter III). Appropriate supply- and demand-side resources and instruments must be made available to ensure that SMEs obtain the loans they need, as guarantee mechanisms alone are not enough. SMEs need the capital market in order to cope with emergencies, invest in education and training, carry out production activities and modernize.

[22] In the countries of the region, bank financing for the production sector targets mainly large companies and is much more costly for SMEs than for larger businesses.

This means that specialized credit entities and guarantee mechanisms should be created to accomplish what the market is generally unable to do spontaneously. The top priority in this field should be to offer favourable access to long-term financing, at normal interest rates, and to the other resources currently lacking among these underserved sectors: technology, certain inputs and associated services, marketing channels and infrastructure. It is equally crucial, if these units with their more limited resources are to thrive, for the production process to take place in a real economy that enjoys relative stability.

The development of SMEs is critical if countries hope to overcome the deep inequality between the few large companies and the majority of other, smaller ones and advance towards labour markets that are able to create more and more high-quality jobs. Improved access for SMEs to financing will have a direct impact as it will generate more and better employment and thus making a substantial contribution towards narrowing the considerable labour productivity gaps. This is a cornerstone for achieving greater social equality, an issue that will be discussed in further detail in chapter III.

Designing and constructing an inclusive financial system specifically to finance production requires the expansion and development of the set of instruments to control risks, diversify access and lengthen repayment periods. These objectives can be met only in the presence of a strong push to finance SMEs and reinvigorate the role of microfinance at different scales and in a variety of institutional settings.

Microfinance plays a key role in improving access to financial services and employment for low-income households and microbusinesses. The scope of action of microfinance is highly heterogeneous. For example, one objective could be to provide microenterprises with financing to purchase simple equipment or to incorporate inactive members of the labour force —especially women— into production activities. This would help generate GDP, improve household welfare and consolidate personal dignity.[23] Given the newfound importance of resources mobilized through the remittances of migrants, microfinance institutions in some countries have also experimented with financing production development for people who receive these resources from abroad. Microfinance institutions in a number of the region's countries, as one of their basic activities, provide technical and strategic support to loan recipients. In certain cases, such as Ecuador, they have helped groups of clients set up production clusters to lower production and distribution costs. In others, such as the Plurinational State of Bolivia, Honduras and Nicaragua, they have helped borrowers of microcredit identify new markets for their products. Such experiences need to be strengthened and instituted in other countries.

To encourage the development of microfinance in the region, public policies must be designed for the following objectives: (i) improve the capacity of relevant institutions to channel market resources and develop new products; (ii) tackle management and regulatory challenges so as to facilitate risk monitoring and management; (iii) apply low-cost technologies that are affordable for institutions of this kind; and (iv) move towards the creation of instruments that facilitate more effective evaluation of the impact of microfinance.

[23] At present, microfinance institutions in countries including the Bolivarian Republic of Venezuela, Colombia, Guatemala, Nicaragua and the Plurinational State of Bolivia also offer a variety of insurance programmes to their clients. At first the focus was essentially on basic medical and funeral services, but in recent years the coverage has expanded and now covers crops and capital goods financed through microcredit, as in the case of the Plurinational State of Bolivia.

The countries need to develop a financial system that will reduce the great structural heterogeneity in the region's economies. As chapter III suggests, this system should target sustained productivity increases in small- and medium-sized enterprises. Today's incomplete capital markets have posed an insurmountable barrier that has prevented many SMEs from stepping up their development. This is an essential ingredient for bringing about growth with equality. Reform of the capital markets therefore means strengthening public banking, particularly development banking, as an instrument to boost and democratize access to credit, especially long-term credit oriented towards financing of productive investment.

Financial markets are typically hampered by problems of information, making it difficult for SMEs to gain access to credit and dampening innovative activities in general. These problems are compounded by the impact of the maturity mismatch between obligations that financial intermediaries acquire to obtain resources, and the needs of potential borrowers, especially when resources are to be allocated for investment. These difficulties tend to be more acute in volatile, unstable economies, such as those of Latin America, where depositors have a high preference for liquidity.

Private banks, which are generally subject to strict regulation and supervision, operate with a shorter horizon in terms of profits and use market criteria for their risk management programmes. Thus they tend either to favour enterprises that are relatively larger and well-established or are able to offer real high-value guarantees, or else to focus mostly on short-term credit —to the detriment of long-term financing— for small companies or new ventures or projects whose potential profitability is more uncertain. It is these new ventures or projects, which lack timely access to financing from private banks, that are most likely to introduce new products or new ways of producing them and to seek out new markets. These biases in the private banking sector are not good for investment or growth because they fail to encourage innovation, long-term productivity or the narrowing of production and social gaps.

The introduction and development of instruments such as leasing with an option to buy, factorization, guarantee systems or venture capital is a move in the right direction, but not enough to eliminate the problem of credit rationing. That goal requires the strengthening of public development banking. Public banks operate under different criteria than private banks in terms of profitability, risk management and funding of resources and are therefore in a better position to focus on financing investment and working capital for companies that do not have ready access to credit. This would not only have a positive distributive effect, but would also increase the overall growth potential in the economy by allowing more production units to join the process.

Moreover, development banking can play an essential role in providing countercyclical financing. For example, the Government of Brazil recently responded to the global crisis by boosting the capital of the National Bank for Economic and Social Development (BNDES) by 3.5% of GDP in order to augment its credit potential and partially offset the decline in private credit: in 2009, public credit made up 41% of total credit. This institution played a leading role in reactivating the Brazilian economy.

Given the extreme heterogeneity in today's economies, financial development must boost access to credit for micro-, small- and medium-sized enterprises. This is consistent with commitments acquired under the Monterrey Consensus (United Nations, 2002 and 2007). Development that produces more equitable markets and a dynamic economy requires a financial infrastructure that is able to provide microenterprises and SMEs with access to a diverse range of sustainable products and services that will strengthen weaker segments over the long term. It also needs diversified financial instruments that make it possible to adopt countercyclical measures.

In short, a reform of the reforms of the Washington consensus must attach top priority to linking the financial system up with the domestic investment process and the domestic economy rather than with external financial markets. It must also contribute to greater economic stability, which means avoiding exchange rates that are out of alignment and regulating interest rates in order to temper the frequency and aggressiveness of cyclical fluctuations and avoid real interest rates that are either negative or too high. Finally, the reform should seek to decentralize economic power by using inclusive financing mechanisms that give preferential access to SMEs (Ffrench-Davis, 2005).

(c) The balance-of-payments financial account and development financing

Reforms of domestic capital markets went hand in hand with liberalization of the balance-of-payments financial account. Total external financial opening, as occurred in the 1990s and during this decade, generally leads to integration into the most speculative sectors of the developed world. Consequently, the most buoyant segment of the capital market has been short-term financial inflows and outflows characterized by procyclical volatility and having little connection to productive investment. Even so, it is now clear that the original objective of liberalization —financing more investment and higher productivity to boost economic growth— remains elusive. Instead, the process has opened the way to intense cyclical instability imported through the financial account. Effective regulation of the financial account is now understood as an indispensable condition for moving towards a development-oriented macroeconomic scenario framed by monetary independence and exchange-rate sustainability.

Regulations on the financial account can serve as a prudential macroeconomic policy instrument as they target volatile flows, which are the direct source of boom and bust cycles. If they are effective, they relieve the pressure for exchange-rate appreciation and make it possible to adopt contractive monetary policies during periods of financial euphoria. Similarly, regulations tend to reduce the quasi-fiscal costs of sterilized international reserve accumulation. If such regulations are in place, during the down cycle (marked by active external restriction), expansive monetary and fiscal policies can be adopted to tackle the recession, which is extremely useful in situations such as today's global crisis.

Experience has generally confirmed the benefits of imposing volume or price restrictions on the entrance of liquid or short-term capital as they facilitate the adoption of countercyclical macroeconomic policies and improve the maturity profiles of external liabilities (Ocampo, 2007; Williamson, 2003). Regulations of this kind are designed to create a more stable macroeconomic environment in boom times and minimize the costly recessionary adjustments needed when the economy descends from disequilibria caused by overheating. An environment with regulations is better adapted to the market and more equipped to meet the following goals: (i) make irreversible investment decisions; (ii) avoid major gaps between real GDP and potential GDP; (iii) prevent macroeconomic prices —exchange rates and interest rates— from falling too far out of alignment; and (iv) warding off disequilibria in other key macroeconomic ratios associated with the appearance of areas of vulnerability (unsustainable current account deficits, price/earnings ratios on the stock market and ratios between liquid and short-term liabilities and international reserves).

The debate over capital controls was intensified in response to the well-publicized measures adopted by Malaysia in 1998. The Government imposed tight quantitative restrictions on the outflow of capital (Kaplan and Rodrik, 2001), which turned out to be crucial for applying the active monetary and fiscal policies that reactivated the economy in 1999.

Knowing how to move on from a crisis after having been through it is not enough. Averting a crisis altogether or drastically mitigating its costs is as important if not more so. This is one goal of the regulation of capital flows that aims to achieve sustainable equilibria in the real economy. In recent years, there have been several noteworthy attempts in the region, such as in Argentina, Brazil, Colombia and Peru (see box II.2), to regulate capital flows to achieve these equilibria, mostly to prevent excessive exchange-rate appreciations (ECLAC, 2009a).

A significant development at the beginning of the 1990s was the Chilean experience with countercyclical regulation of capital income. Faced with high levels of external financing (in relation to GDP) that could have had a destabilizing effect, Chile introduced a reserve requirement on capital income other than foreign direct investment. During the five years from 1991 through 1995, exchange-rate appreciation and the current-account deficit as a share of GDP were below the average for the region as a whole and for other countries of Latin America that received huge capital injections at that time.[24] The disincentives on short-term inflows made room for active exchange-rate and monetary policies. Chile successfully controlled the composition of income by engineering a significant drop-off in liquid and short-term flows (Larraín, Reisen and von Maltzan, 2000).

Multiple econometric tests confirm that foreign direct investment is much less volatile than short-term indebtedness and portfolio flows and that it makes sense to adopt prudential policies for macroeconomic regulation —such as reserve requirements— that target short-term or volatile flows (Agosin and Ffrench-Davis, 2001, table 4). As this chapter has shown repeatedly, persistent flows generally go into productive investment rather than consumption, while the likelihood of a crisis and the seriousness of its consequences seem to be closely associated with greater liquidity of net external liabilities (Rodrik and Velasco, 1999). The Chilean regulations, together with sterilized intervention in foreign-exchange and money markets, staved off excessive exchange-rate appreciation and prevented a consumption boom, thus holding the current account deficit within reasonable limits until the mid-1990s (Le Fort and Lehmann, 2003; Williamson, 2003). Thus, Chile's economy persistently operated near its production frontier, which during that period produced a virtuous circle of high productive investment, high GDP growth —averaging more than 7%— and declining inflation.

These are examples of positive experiences with regulation of capital income. Other measures are associated with the outflow of domestic capital. The Republic of Korea, for example, maintained strict controls on capital for several decades: following the liberalization of capital income, which culminated with the 1998 crisis (Agosin and Ffrench-Davis, 2001), controls were imposed on external monetary transfers by residents (Mahani, Shin and Wang, 2005). In some countries of Latin America and the Caribbean, reforms and the transformation of pension systems into private capitalization funds have created significant long-term sources with growing volumes that have given rise to steadily expanding institutional savings. The neoliberal approach has exerted pressure to liberalize the management of these funds and to allow them to be moved overseas freely. Naturally, if the room for manoeuvre is too ample, they can become a source of macroeconomic instability.[25] These are large-volume funds of a very long-term nature. As a result, any reform of the reforms must grant them a critical role as a factor for real macroeconomic stability (Zahler, 2005) and as a key element for gradually restructuring the capital market to achieve capital formation and productive development.

[24] See quantitative background in Ffrench-Davis (2005, chapter VI and 2008a, chapter VIII). Agosin and Ffrench-Davis (2001) and Le Fort and Lehmann (2003) examine numerous features of the reserve requirement, its application and effects, and analyse the critical literature.

[25] Authorities in Singapore took a very different approach, using a semi-public pension fund as an effective instrument for stabilization.

Box II.2

CAPITAL CONTROL: AN OUNCE OF PREVENTION

Several important economic policy lessons can be learned from the absence of prudential macroeconomic regulation of capital inflows. With their predominantly passive positions, national economies were left vulnerable to external shocks, lending tremendous volatility to key domestic macroeconomic prices —exchange rates and interest rates— and to macroeconomic aggregates, especially the gap between effective demand and potential GDP, and the external balance. As investments dip, these fluctuations exert an adverse effect on long-term growth, productive employment and equality. In more recent years, several countries of the region have intervened in the financial account to ward off excessive volatility in capital flows or exchange-rate values.

In the 1990s, Chile and Colombia began systematically applying non-remunerated reserve requirements on financial capital income; one of the objectives was to keep exchange rates competitive for the production of tradable goods, create space for monetary policy and regulate domestic demand and the external balance.

Starting in June 2005, Argentina required anyone bringing in foreign currency to deposit in dollars an amount equivalent to 30% of the total value of the operation. This mandatory deposit is applied, with certain exceptions, to different types of capital flows, such as debts of the financial and private non-financial sector, primary stock issues of resident companies that are not publicly traded and trading in self-regulated markets. It also applies to portfolio investments by nonresidents in local-currency stocks and foreign-currency income earned on the local exchange market through the sale by residents of external assets amounting to more than US$ 2 million per calendar month, as well as other operations intended to prevent tax evasion and leakage. A minimum repayment period of 365 days is required for overseas debts and debt turnovers by residents; such debts cannot be paid off before this term lapses.

In Colombia, from May 2007 through October 2008, international investors were required to make a non-remunerated deposit for stock portfolio investment from abroad, and foreign direct investment required a minimum stay of two years. At first the required deposit was 40% of the total amount, rising to 50% in May 2008. These requirements were removed in response to the international crisis, specifically for new overseas investments in stocks or mandatory convertibles and for the acquisition of portions of collective portfolios consisting of stocks only. Nevertheless, the deposit requirement remained in effect for other portfolio investments from abroad, especially fixed-income assets.

In Peru, in addition to direct intervention in the foreign exchange market, the central bank adjusted dollar reserve requirements as a tool to manage domestic liquidity in foreign currency. In early 2008, in response to surging capital inflows, the Government stepped up intervention in the foreign-exchange market, increasing the reserve requirements in new soles and dollars as a way to lessen the need for sterilization. In order to further limit capital inflows, the central bank temporarily stopped issuing certificates of deposit, replacing them with auctions of nontransferable deposits and non-negotiable certificates of deposit, which could be acquired only by national financial entities, so that in effect, they served more as instruments for controlling liquidity and less as investment assets that would attract international investors. The bank also began charging a commission for transferring ownership of Central Reserve Bank of Peru (BCRP) certificates to nonresidents. Nonetheless, under the terms of its recent free trade agreement, Peru now has a more restricted capacity to impose measures that discriminate against investors from the United States.

In October 2009, Brazil introduced a 2% tax on capital flows for acquisition of stocks and bonds, excluding foreign direct investment. Shortly thereafter, a 1.5% tax was placed on American Depositary Receipts (ADRs) for Brazilian firms trading on the New York exchange. Significantly, during the earlier period of significant nominal appreciation of the real, Brazil had charged a 1.5% tax on foreign investment in fixed-income assets, which was eliminated in October 2008 following the onset of the international financial crisis.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean, 2009* (LC/G-2424-P), Santiago, Chile, 2009. United Nations publication, Sales No. E.09.II.G.149.

Other more traditional controls are also available. For example, China and India introduced bans on short-term financial debt, placed quotas on stock investments and controlled capital outflows. These have proven to be a very effective means for achieving the macroeconomic policy objective of minimizing the close associations between the domestic economy and volatility on international markets. Both countries successfully withstood the current crisis, blocking the transmission of external recessionary shocks that have struck nearly all the world's economies, whether developed, emerging or in transition. With these controls, they were able to implement the impressive reactivation programmes now under way.

The effective countercyclical regulation of capital account inflows and outflows can provide the financial system with the room it needs to reorganize its operations and channel resources into savings and investment in direct association with the needs of the productive apparatus. In practice, however, the procyclical and volatile nature of external financial flows has conspired against achieving more financial intermediation to facilitate development in the region. This means the countries must develop a greater capacity to attract external savings and direct them into financing production, supporting growth and employment, working to integrate their societies and lessening the structural heterogeneity among the various production sectors.

(d) The great macroeconomic challenge in short: managing capital flows

The low rate of investment over the past two decades reveals persistent structural flaws in domestic capital markets and their linkage with international markets. The negative impact of these flaws has been worsened by weaknesses in the national macroeconomic environment.

Nonetheless, a number of important lessons have been learned. The effects of the recent financial crisis, which threatened to be as dramatic as the Great Depression of the 1930s, were tempered not by feats of magic or by self-adjustment of the markets, but by deliberate public action to salvage the macroeconomic environment of the world economy following the financial erosion that occurred in the second half of 2008. The correction required actions that ran counter to the prevailing paradigm of a passive State and an essentially neutral economic policy. It overcame any opposition to using available instruments, especially fiscal policy, for countercyclical purposes. The world's major economies responded with a robust countercyclical fiscal policy. Now that collapse had been averted, the corrections need to be strengthened. This does not mean the crisis is over or that recessionary conditions have ended; but it is reasonable to hope that economic activity has begun to rebound in the region and in the rest of the world.

Today's major challenge is to see that recovery from the crisis is sustainable, especially if, as this chapter suggests, the goal is to create an environment for work and productive capital that fosters dynamic development. The preceding pages have shown how different macroeconomic approaches have a decisive influence on the degree of stability and on the ways in which stability determines the direction and pace of growth and the fairness of domestic markets. The financial system must play a vital and fundamental role in attracting savings and channeling them into investment. Foreign capital can play a valuable part as a supplement to domestic savings, for which purpose the composition and stability of flows is crucial. Indiscriminate financial liberalization did not engender productive development or bring about real macroeconomic stability and in fact was counterproductive for meeting objectives associated with reducing

inequality. In the countries of this region, the global crisis —an illustration of the risks of unregulated financialism— has opened the way to more pragmatic policies for countercyclical regulation of the capital account.

Sustainable development requires public policies that are conducive to social inclusion, and it calls for countries to be engaged with the international economy based on growing domestic integration and less social disintegration. Decisions must therefore be made about how to reform domestic capital markets and how to develop the link with international financial capital markets. This is the critical challenge for achieving a macroeconomic context that sets the region on a sustainable course of economic and social development.