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Schweickert, Rainer

Book Review

[Book Review of] Coping with capital surges : the return of finance to Latin America, Ricardo Ffrench-Davis ... (eds.) : Boulder, Rienner, 1995

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theoretical disputes in economics are generally a mere facade for the permanent struggle between believers in unfettered markets and supporters of public sector interventionism. Both political camps use theoretical as well as empirical arguments largely for disguising their true political message. According to Corry, neither does economic theory in reality adhere to political neutrality nor has the growing use of empirical tests helped the profession much in becoming less ideologically biased. This reasoning is backed up by describing the evolution of mainstream macroeconomic thought and its interplay with political beliefs from classical economics to Keynes and back to the natural rate. Nowadays, the tide seems to turn back in favor of more government interventions due to a concentration of research activities on market failures. As economists vacillate so much between very different proposals for economic policy, their reputation has deteriorated dramatically in the last 30 years. Real world financial and business experts are usually preferred for giving advice on economic policy.

Overall, the book contains a rich overview of the issues involved in the NRH from very different angles. However, after having carefully read the book, the reader is a bit puzzled whether the NRH still is a powerful concept for macroeconomic analysis. Unfortunately, the book is also by no means specific in explaining why unemployment in Europe is so high and in making suggestions for its struggle against unemployment. Yet, after all the public at large mainly demands useful policy advice together with accurate economic forecasting from economists. But as *Olivier Blanchard* notes in his preface, it is not yet time for a synthesis and the research on how to fight unemployment effectively is still very much in progress.

Rainer Fehn

Ffrench-Davis, Ricardo, Stephany Griffith-Jones (Eds.), *Coping with Capital Surges. The Return of Finance to Latin America.* Boulder, Ottawa 1995. Lynne Rienner Publ. and International Development Research Centre. X, 277 pp.

This collection of papers clearly differs from others: it has a surprisingly clear concept which is given in the preface. The first group of papers deals with sources of flows, distinguishing between North American lending and investing (the main source of private flows to Latin America in the 1990s), European lending and investing (second to the United States in importance), and Japanese funding (characterized until now by their rather low level). Each of the chapters on sources of financial flows analyzes separately foreign direct investment, securities (both bonds and shares), and bank lending, as well as examining the motivations of lenders and investors and existing regulations that affect such flows. The second group of papers deals in depth with Chile, Argentina, and Mexico. All three countries are among those that have experienced particularly large increases in their capital inflows in the early 1990s. Emphasis is placed on policy responses fundamentally related to attempts to moderate the impact of capital inflows on appreciating the exchange rate, to reduce the monetary impact of foreign exchange operations, and to moderate capital inflows, particularly of a short-term nature. The third section of the book draws out the policy implications for recipient countries and lessons from the capital market case studies. Even more surprisingly than the clear concept, the authors adopted this structure when writing their papers. As a consequence, the book allows for both selective and comprehensive reading without wasting too much time for understanding the concept of the individual papers and their contribution to the issue. Well done!

Somewhat unsystematic, however, both *Roy Culpeper* (Chapter 1 on 'Resurgence of Private Flows to Latin America: The Role of North American Investors') and *Stephany*

Griffith-Jones (Chapter 2 on 'European Private Flows to Latin America: The Facts and the Issues') start with putting the regional view into a global perspective. This is confusing to the extent that different data sources and different perspectives are used to tell the same story twice. A chapter on 'facts' introducing the first group of papers in source countries would have been a good idea.

Unsystematic as well, *Griffith-Jones* examines at the end of her chapter 'what the potential for volatility of such flows is and what the negative effects of such volatility could be, as well as how policymakers should attempt to minimize both' (p. 66). These questions are addressed in the second group of papers on recipient countries. Even more surprisingly, she concludes "Finally, it should be stressed that, globally, regulations of international capital flows have evolved well behind the flows themselves. This is partly due to technical difficulties, the great complexity of the task, and lack of political will in the major industrial countries. Although the tide is turning, the regulatory response seems always 'too little, too late' " (p. 71). My reading of the recent literature is that the tide is turning for less rather than more regulation of financial markets in industrial countries.

Apart from these confusions, both chapters as well as the chapter by *Punam Cluhan* and *Kwang W. Jun* (Chapter 3 on 'Latin American Financing in Japan's Capital Markets') give a rather comprehensive view about market potential and market regulations of the three main capital markets combined with concrete advice for Latin American policymakers.

Culpeper shows the trend from bank lending to portfolio flows (either of the fixed income or the equity type) and forcing direct investment (fdi). He points to the importance of complete, consistent, and prompt reporting of secondary market and derivative transactions and the implementation of standardized generally accepted accounting principles in order to smooth capital flows and the secure an 'investment grade'.

Griffith-Jones shows the heterogeneity of European investors. 'There is a particularly sharp contrast between the United Kingdom, where pension funds distribute their foreign assets by putting only 6 percent into foreign bonds and as much as 94 percent into foreign equities, and Germany, where pension funds distribute their foreign assets by putting as much as 93 percent into foreign bonds and as little as 7 percent into foreign equities' (p. 50). But she also identifies a lot of common features: they 'are willing to have a wide range of exposure in terms of countries within Latin America, that the more 'conservative' U.S.-based investors, who concentrate far more on investment in Mexican equities (pp. 56/57). – Once they decide to go into a particular region or country, they tend to invest in the whole range of instruments in that particular country, including equity, bonds and short-term instruments' (p. 58); and 'Among the criteria attracting investors a major change in economic philosophy toward more free-market economics, which is broadly seen as permanent, increased growth and growth prospects prudent macro-economic management and improved political stability' (p. 60). The chapter also includes a detailed discussion of relevant regulations in Europe and of the decision-making process of large institutional investors which should help Latin American borrowers to establish stronger links to European investors.

Cluhan and *Jun* point out that regulations of the Japanese capital market restrict an increase in Japanese portfolio flows to developing countries. Even recent efforts to relax such regulations are rather likely to increase outflows to East Asia rather than to Latin America. According to the authors 'this can be explained by the different policies in these two regions in the 1980s. East Asian countries generally had more export-oriented policies and those in Latin America were more inward-oriented' (p. 95).

The second group of papers dealing with capital inflows to Latin America is as strong in its descriptive parts as the first group of papers. Readers interested in the extent and the structure of capital inflows and domestic policies targeted towards either attracting or dampening inflows (or their consequences respectively) will find the relevant information. It could be questioned, however, whether it is necessary to repeat the experience made during the depth crisis once again.

Ricardo Ffrench-Davis, Manuel Agosin and *Andras Uthoff* (Chapter 4 on 'Capital Movements, Export Strategy, and Macroeconomic Stability in Chile') explain how Chile used a consistent package of exchange rate, monetary, and fiscal policies to discourage short-term capital inflows. The riskiness and the costs of short-term investment was systematically increased by trading inflows, by increasing the exchange rate band, by discretionary changes of the central parity (a passive crawl), and by discretionary interventions within the band. Stabilization policies have been made possible by fiscal savings and a relatively well-developed financial market.

Given this information, the conclusions in this chapter are rather ad hoc and surprising: 'The recovery of international economic activity and interest rates may cause significant reversals of capital flows, regardless of Chile's domestic policies' (p. 136) – in the meanwhile we know that Chilean policies did not only moderate inflows but also prevent outflows in the aftermath of the Mexican Peso crisis; 'The exchange rate has fluctuated and appreciated, despite the efforts of the monetary authorities, with greater intensity than what appeared to be their preference' (p. 138) – the foregoing analysis rather emphasized that (after a decade of prudent macroeconomic policy) gained what developing countries in Latin America are keen on: a relatively smooth development of capital inflows.

In this respect, Argentina and Mexico are clearly different although both countries made considerable efforts since the mid-1980s as shown by *José Maria Fanelli* and *José Luis Machinea* (Chapter 5 on 'Capital Movements in Argentina') and *José Angel Gurria* (Chapter 6 on 'Capital Flows: The Mexican Case'). While Argentina adopted a market-based approach (fixed exchange rate, full convertibility), Mexico established a social consensus model (active crawl, Pacto agreements). By now we know that the former was more successful than the latter. The chapter on Argentina also contains a convincing analytical part on the relationship between capital flows, stability and growth (pp. 176–183).

The summary chapter by *Robert Devlin, Ricardo Ffrench-Davis,* and *Stephany Griffith-Jones* (Chapter 7: Surges in Capital Flows and Development: An Overview of Policy Issues) is excellent. The authors explain the importance of external savings as a complement to domestic savings, they summarize supply-side and demand-side aspects, and they formulate the policy alternatives in a higly efficient way. I would suggest to read this chapter first and to pick up the details from the other chapters. This does not imply that one has to accept the message – to allow for managed inflows. The exogenous character of changes in capital flows and their negative impact on the economy are, at least, slightly overemphasized. Comparing Asian with Latin American experiences tells a different story. Also, global regulation is not likely to smooth the supply of financial funds significantly, exchange stabilization funds have negative incentive effects, and social contracts do not provide a third way between the Argentine and the Chilean approach.

But at the time when the book was completed, i.e. before the Mexican Peso crisis, the authors have been in good company with their assessment and – most importantly – they do not hesitate to deliver a clear hypothesis which the reader could check by reading the book. In my view, this would be a worthwhile exercise for both academics and policymakers interested or involved in the development of Latin American countries.

Rainer Schweickert