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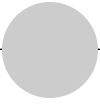
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Introduction

Sebastian Edwards and Márcio G. P. Garcia

During the last few years globalization has been under attack from different quarters. Many critics—including some prominent economists—have centered their analyses on the effects of free capital mobility. It has been argued, for example, that unrestricted capital mobility generates financial and macroeconomic instability in the emerging markets. In his critique of the U.S. Treasury and the International Monetary Fund (IMF), Nobel Laureate Joseph Stiglitz (2002) has argued that pressuring emerging and transition countries to relax controls on capital mobility during the 1990s was highly irresponsible. Stiglitz goes as far as arguing that the easing of controls on capital mobility were at the center of most (if not all) of the recent currency crises in the emerging markets—Mexico 1994, East Asia 1997, Russia 1998, Brazil 1999, Turkey 2000, Argentina 2001. Even the IMF has criticized free capital mobility and has provided (at least some) support to capital controls. Indeed, in a visit to Malaysia in September 2003, Horst Koehler, then the Fund’s managing director, praised the policies of Prime Minister Mahatir, and in particular its use of capital controls in the aftermath of the 1997 currency crises (*Financial Times*, September 15, 2003, page 16). An important point made by critics of capital mobility is that most of the emerging markets lack the institutional strength to take full advantage of an open capital account (Rodrik and Kaplan 2003).

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According to this view, weak financial supervision and poorly developed domestic capital markets transform large changes in capital mobility in macroeconomic volatility. In many cases, sudden changes in capital inflows may result in significant and abrupt current account reversals, crises, and currency collapses. In some countries these problems are compounded by the existence of widespread dollarization (Calvo 2003). In this case, large (and not so large) nominal depreciations will affect balance sheets of domestic firms and tend to generate massive bankruptcies. To the extent that these sizable changes in the nominal exchange rate may be generated by abrupt declines in capital inflows, reducing the extent of capital mobility may be a desired policy action. Under these circumstances, strengthening financial markets is a key challenge for the emerging countries. These topics were discussed at the 2005 meeting of the Inter-American Seminar on Economics (IASE 2005) held on December 1 to 3, 2005, at the beautiful campus of the Pontifical Catholic University (PUC-Rio), Rio de Janeiro, Brazil. The IASE 2005 provided a setting for the interaction of NBER scholars with Latin American academics, policymakers and financial markets practitioners. This volume contains most of the papers and comments that were presented at that conference.

The IASE 2005 covered five broad issues related to financial markets and economic performance in an increasingly globalized world: finance and trade, capital flows and crises, global financial integration, domestic credit, and economic policy in emerging markets. In addition, there was also a very opportune panel, *Economic Policy in Latin American Countries: Revival of Populism?*

Many of the papers collected in this volume deal with different aspects of capital mobility and controls. A unifying theme among these contributions is whether capital controls help reduce macroeconomic volatility. The analyses presented deal both with cross-country evidence as well as with country-specific episodes. Some of the papers recognize that the extent of capital mobility is not an entirely exogenous variable and that it depends on economic developments. The papers presented at the IASE 2005 also deal with sudden stops of capital inflows, current account reversals, capital markets regulation, and dollarization. In this introduction we provide a brief summary and commentary of the papers in the volume.

A Brief Guide to the Volume

The first paper in the volume is by Joshua Aizenman and Ilan Noy and is titled “Links between Trade and Finance: A Disaggregated Analysis.” In this contribution Aizenman and Noy examine the intertemporal feedbacks between disaggregated measures of trade and financial flows in developing countries. More specifically, they analyze the impact of (lagged) disaggre-

gated measures of trade in goods, services, and incomes on disaggregated financial measures of foreign direct investment (FDI), portfolio loans, and trade credit flows. Lagged average trade is found to be correlated with FDI and loan flows, but not to equity and trade credit measures. The authors also find that the investment incomes accounts correlates positively with FDI, as FDI profits are repatriated. The most general empirical finding is that the increase in financial openness has been associated with an increase in FDI and equity flows but with a decline of the importance of loans.

An important implication of this work is that it suggests that, if embodied in the appropriate model, different measures of trade openness may be used to help construct indexes of capital mobility. The advantage of doing this resides on the fact that measures of trade openness (and restrictions) are more readily available than measures of financial integration.

The second contribution in the volume is “Ineffective Controls on Capital Inflows under Sophisticated Financial Markets: Brazil in the Nineties,” coauthored by Bernardo Carvalho and Márcio G. P. Garcia. According to their econometric estimations, controls on capital inflows in Brazil were effective in deterring financial inflows for only a brief period, from two to six months. To uncover the causes of this ineffectiveness, Carvalho and Garcia decide to travel a novel methodological route; they asked financial traders what they did to get around and avoid the regulations. They collected several examples of the financial strategies engineered to avoid the effects of capital controls and, thus, to invest in the Brazilian fixed income market. The most popular methods consisted of disguising fixed income investments as other forms of investments that were not subject to the controls, including investments in the stock market or FDI. Because at the time Brazil had already quite a sophisticated derivatives market, those financial instruments were also widely used to bypass the controls. The main conclusion of this paper is that while controls on capital inflows may be desirable at a conceptual level, their effectiveness is very limited effectiveness under sophisticated financial markets as the Brazilian one. Their conclusion is of particular importance nowadays, when financial inflows cause the domestic currencies to appreciate in emerging markets. When sterilization policies became too expensive or ineffective to deter the appreciation of the real exchange rate, governments may flirt with the idea of controls on capital inflows. Carvalho and Garcia’s paper suggests that the effects of this type of policy will be temporary at best.

The chapter by Sebastian Edwards is “Financial Openness, Currency Crises, and Output Losses.” He uses a broad multicountry data set to analyze the relationship between restrictions to capital mobility and external crises. The question is whether, as critics of globalization such as Stiglitz have argued, the effects of a currency crisis on growth are lower in countries with stricter restrictions on capital mobility than in countries with freer

mobility of capital. In order to address this issue, Edwards constructed a new data set on financial markets integration; he also uses two alternative definitions of exchange rate crises. Edwards's empirical results suggest that external currency crises have resulted in sharp decline in gross domestic product (GDP) per capita growth and that such effect is smaller in countries that use their international reserves to cushion the consequences of the crisis. These results are consistent with the idea, advanced almost fifty years ago by Albert O. Hirschman, that devaluations are contractionary. Edwards finds no evidence, however, suggesting that the effect of crises has been smaller in countries that restrict capital mobility than in countries with freer cross-border capital flows. Edwards points out that his results may depend on his measure of capital controls and capital mobility and argues that further progress in understanding the important issue of the consequences of liberalizing capital movements will require additional and better quality data.

The fourth chapter is by Augusto de la Torre, Juan Carlos Gozzi, and Sergio L. Schmukler and is titled "Capital Market Development: Whither Latin America?" In this useful contribution, the authors analyze the current status of the financial market reforms in the Latin American region. They argue that in spite of successive rounds of reform, capital markets in Latin America remain underdeveloped and that the positive effects of financial liberalization—including higher domestic savings and better conditions for financing smaller firms—have not materialized. This "underdevelopment" is particularly acute when compared with the expectations that policymakers and analysts had about the effects of reforms; it may be a case of "overly optimistic expectations," where reforms were oversold by their proponents. The authors argue that expectations about the outcome of the reform process may need to be revisited to take into consideration intrinsic characteristics of emerging economies that may limit the scope for developing deep domestic capital markets in a context of international financial integration.

The chapter by Ana Carla A. Costa and João M. P. De Mello is "Judicial Risk and Credit Market Performance: Microevidence from Brazilian Payroll Loans." The authors argue that the judicial ruling in Brazil that declared illegal the withholding of due credit installments directly from the payroll is an exogenous event that helps assess whether such legal decisions have an impact on market performance. Their original data set comes from the Brazilian Central Bank's Credit Information system and includes bank level information on interest rates and amount lent in several different risk categories, for both personal loans with and without payroll deduction. By comparing the dynamics of these two categories, the authors found that judicially imposed restrictions had an adverse impact on risk perception, interest rate, and amount lent. As a result of the legal ruling the equilibrium

amount of credit decreased by almost 6 percent, and interest rates increased 7.5 percentage points (the average interest rate on payroll loans over the period was 45 percent annually). These results are important as they provide microeconomic evidence that institutional factors matter and can explain differences in capital markets' performance across countries. The results also provide support for findings at the macro level on the effects of regulation and institutions on capital markets behavior.

In his contribution to IASE 2005, Eduardo Levy Yeyati analyzed the functioning of capital markets in dollarized economies. "Liquidity Insurance in Financially Dollarized Economy" studies the implications for liquidity runs in an economy where domestic financial assets are denominated in foreign currency. This situation of dollarized balance sheets is quite common in a number of emerging countries and has been at the center of recent discussions on the dynamics of the 2001 to 2002 Argentine crisis. Levy Yeyati asks the following question: does dollarization impose limits on the central bank as the domestic lender of last resort? And, if so, what are the consequences of foreign currency denominated liabilities when there are dollar liquidity runs? The paper discusses the incidence of financial dollarization on banking crises propensity and shows that it has been a key determinant of efforts to self-insure through the accumulation of sizable international reserves. Levy Yeyati also highlights the moral hazard associated with centralized reserve accumulation. In an interesting discussion, the author addresses two recent episodes (Argentina 2001 and Uruguay 2002), where the authorities suspended convertibility of domestic financial assets into foreign currency. Levy Yeyati finishes his chapter by arguing that a combined scheme of decentralized liquid asset requirement and an *ex ante* suspension-of-convertibility clause or "circuit breaker" would reduce self-insurance costs while limiting bank losses in the event of a run.

The contribution by Barry Eichengreen, Poonam Gupta, and Ashoka Mody is titled "Sudden Stops and IMF-Supported Programs." This paper focuses on the impact of IMF programs on the incidence, severity, and effects of sudden stops of capital inflows. The authors point out that IMF programs are endogenous to countries' econometric circumstances and argue that empirical evaluations of IMF programs should take this into account. In their analysis Eichengreen, Gupta, and Mody correct for the nonrandom assignment of IMF programs across countries and find that sudden stops are fewer and generally less severe when an IMF arrangement exists. They then proceed to inquire when this type of "IMF-based" insurance works more effectively. They find that this form of "insurance" works best for countries with strong fundamentals. Their analysis also indicates that there is no evidence that a Fund-supported program attenuates the output effects of capital account reversals if these nonetheless occur. This

analysis is important for discussions on the future role of the IMF. As the number of actual crises has declined, so has the number of IMF programs. This has led to a rethinking of what will be the role of the institution in the years to come.

We close the volume with the inaugural lecture given by Anne O. Krueger at the opening of the conference. Krueger's topic was "Mutual Reinforcement: Econometric Policy Reform and Financial Market Strength." In this paper, Krueger reviews the Korean high growth experience since the 1960s up to the Asian crisis (1997) and then analyzes the forces behind the 1997 collapse of the currency. Krueger argues that the existence of a large ratio of nonperforming loans (NPLs) in banks' portfolios was the main culprit for this crisis. The currency mismatch that triggered the crisis was created by the need to keep rolling the NPLs over and over. Krueger argues that the Korean case is a clear reminder of the importance of a well-regulated and transparent banking system and the damage that can be inflicted on the economy when the financial sector is not healthy. Krueger argues that weaknesses in the financial sector result in lower growth and make the economy more vulnerable to crises. Financial-sector health depends on a sound regulatory framework, relying on incentives, sound banking procedures that permit the proper assessment of risk, and the progressive widening and deepening of the financial sector to ensure that it continues to meet the needs of the economy. An important message of the Krueger paper is that just like economic policy reform in general, financial sector reform cannot be a one-off; it has to be a continuous process. She argues that reforms implemented in the context of an expanding national and global economy have lower adjustment costs and present fewer political difficulties than reforms that are undertaken during crises. This important point, which contradicts the position taken a few years back by scholars such as Robert Bates, suggests that financial reforms implemented in the midst of a boom are more likely to succeed.

Future Research

The East Asian currency crises of 1997 to 1998 changed economists' views with respect to macroeconomic policy. In the aftermath of these episodes—and of the crises that followed in Russia, Brazil, Turkey, Argentina, Uruguay, and the Dominican Republic—a more prudent approach toward macroeconomic management has emerged. The overall objective of this new approach is to reduce vulnerability to external shocks and to lower the likelihood of external crises, including sudden stops and major devaluations. This new view on macro policy has recognized the need of maintaining the public and external debts at prudent levels. An increasingly large number of countries has opted to have flexible exchange rates. In addition, the accumulation of international reserves has been used

as a self-insurance mechanism, and current account deficits have generally been kept in check.

In spite of the emergence of a new view on macroeconomic policy, there are still some areas of disagreement. The most important one refers to the appropriate degree of capital mobility in emerging and transition countries. Some authors argue that limiting the extent of international financial integration reduces speculation and helps countries withstand external shocks without suffering massive crises. The papers presented in this volume deal with a number of issues related to the functioning of capital markets under different degrees of capital mobility. The results reported here suggest, by and large, that controls on capital mobility are not very effective. Market participants find ways of going around them, and there is little (if any) aggregate evidence that countries with controls do better than those that do not have them. At the same time, some of the papers in this volume provide evidence suggesting that the financial market liberalization reforms of the 1990s and early 2000s did not generate all the benefits that economists expected.

New research on this area should focus on a number of selected areas: first, there is still need to have better cross-country indicators of the degree of openness of the capital account. Although during the last few years there has been marked progress in this area, there is still need for indexes with a greater degree of granularity. Second, there is need to understand better the effects of capital controls on microeconomic efficiency, including on small firms' ability to raise capital. Third, issues related to endogeneity have to be addressed. In many contexts, capital controls are altered as a result of macroeconomic developments. Although a number of authors—including many collected in this volume—have corrected for endogeneity, we would benefit from further efforts along these lines. Finally, there is a need to investigate the effectiveness of monetary policy in open economies with flexible exchange rates and under alternative degrees of capital mobility. According to basic monetary policy theory, countries that adopt floating rates are able to have an independent monetary policy (in contrast, under fixed exchange rates, the nominal quantity of money is endogenous). However, in order for monetary policy to be truly independent, countries should be able to have, over prolonged periods of time, domestic interest rates that are different from international interest rates, across the yield curve. Some observers have recently argued, however, that this is a difficult condition to achieve in countries that do not restrict, at least partially, capital mobility. For example, analysts in New Zealand have argued that “monetary policy has lost traction.” By this they mean that successive hikes in the policy interest rate have failed to generate an increase in longer rates; these stayed roughly in line with international interest rates. International comparative research in this area would help better understand issue related to the effectiveness of monetary policy.

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