



“Macroeconomic policies: can we transfer lessons across LDC’s?”

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“Many of you are too young to remember, but it was not long ago that the policies pursued by many governments in Latin America, and the courses taught in most universities across the region, reflected more bad economics than good.”

Arnold C. Harberger: “Letter to a Younger Generation”, Journal of Applied Economics”, November 1998

Contrary to the widely held belief that it is not possible to transfer to LDC’s theories and policies designed for Developed Countries, my experience is that there is only one body of economic theory and that the best policies apply to all patients.

**These policies are, for most cases, the simplest:
Market Rules, Free Trade, and Orthodox Monetary and
Fiscal Policy.**

What are Emerging Countries ?

Bloomberg's definition:

Any country with a nascent stock and bond markets, as well as small economies.

World Bank definition:

Countries with a per-capita income smaller than US\$8950.

Our Definition:

EC's lack enough savings and need foreign capital to develop, and

EC's possess an elevated degree of "macroeconomic weakness" that manifests itself into a high level of "country risk".

Country risk affects economic activity through **investment flows** and **financial behavior**.

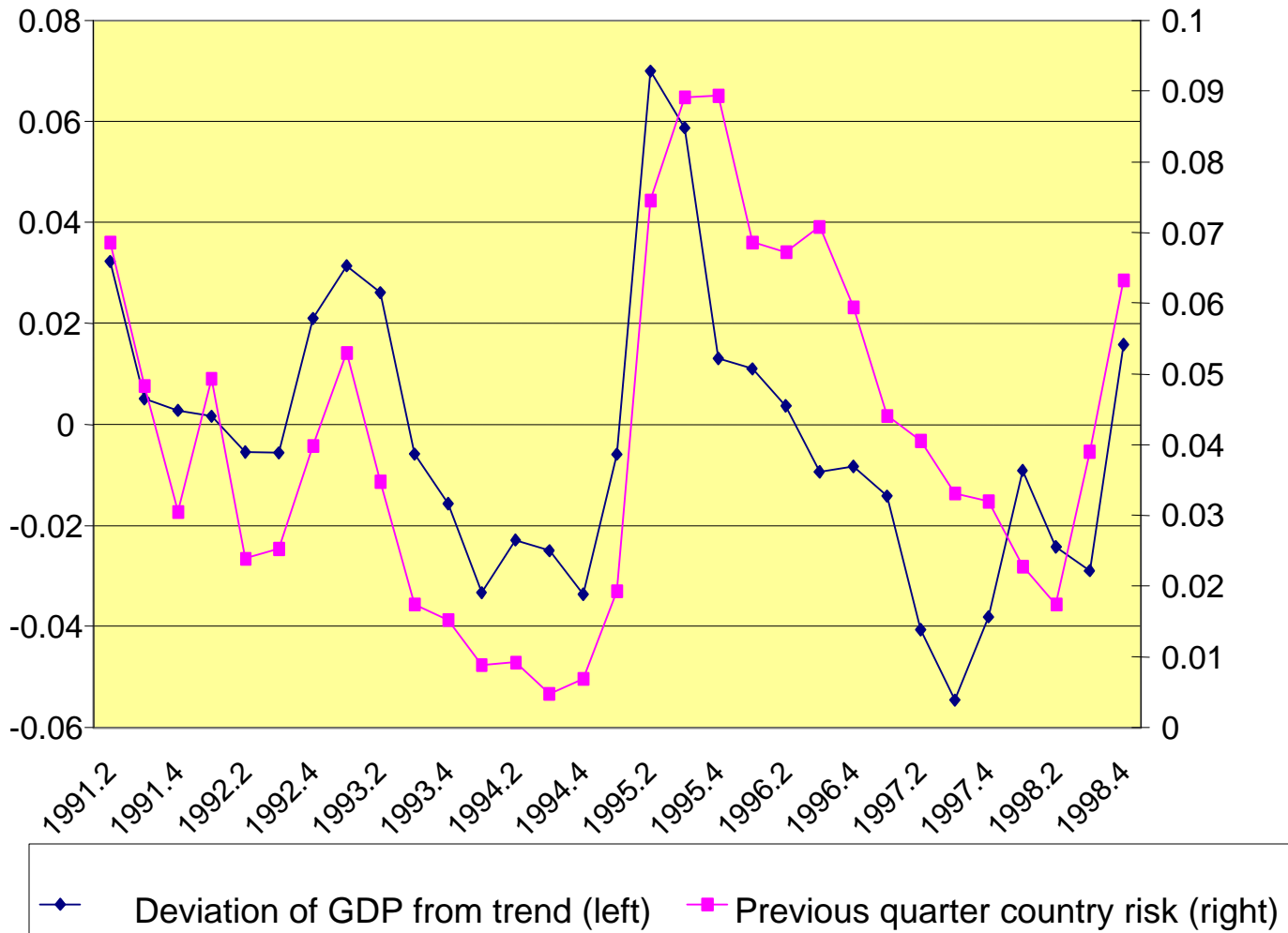
Highly indebted countries following the wrong policies are punished twice: once by the wrong policies and then by investors taking away their money

Clearly, being risky is an expensive business.

Country Risk Premiums for Selected EC's	
Issuer	Average Spread over Treasury Bond (Basis Points)
Argentina (FRB)	722
Brazil (BRA C)	1081
Bulgaria (Discount)	1042
Ecuador (Discount)	3167
Morocco (loan)	677
Mexico (Discount)	787
Panama (PDI)	409
Philippines (FLRB)	485
Peru (FLIRB)	555
Poland (Discount)	303
Russia (INT)	6026
Venezuela (DCB)	1473

*** Spreads correspond to representative Brady Bonds on March 18,1999.
Source: JPMorgan**

Relation between output and country risk. Argentina 1991-98



Investors and Markets are the judges of Country Risk

International capital flows respond faster than any other economic variable.
They can stop suddenly or reverse sign on the expectation of a policy
change

Markets in the last decade have taught hard lessons to demagogues and ideologists. Gone are the widespread experiments with central planning and the policies of "entrepreneurial state" and "desarrollismo".

Determinants of Country Risk:

-Macroeconomic Performance

-Contagion Effect

-Flight to Quality

Macroeconomic Factors Determining Country Risk

Cantor and Packer studied the determining factors for the sovereign credit ratings and they found that eight factors explain more than 90% of the cross sectional variation in the ratings. These variables are:

GDP per-capita

Growth record

Debt burden

Inflation

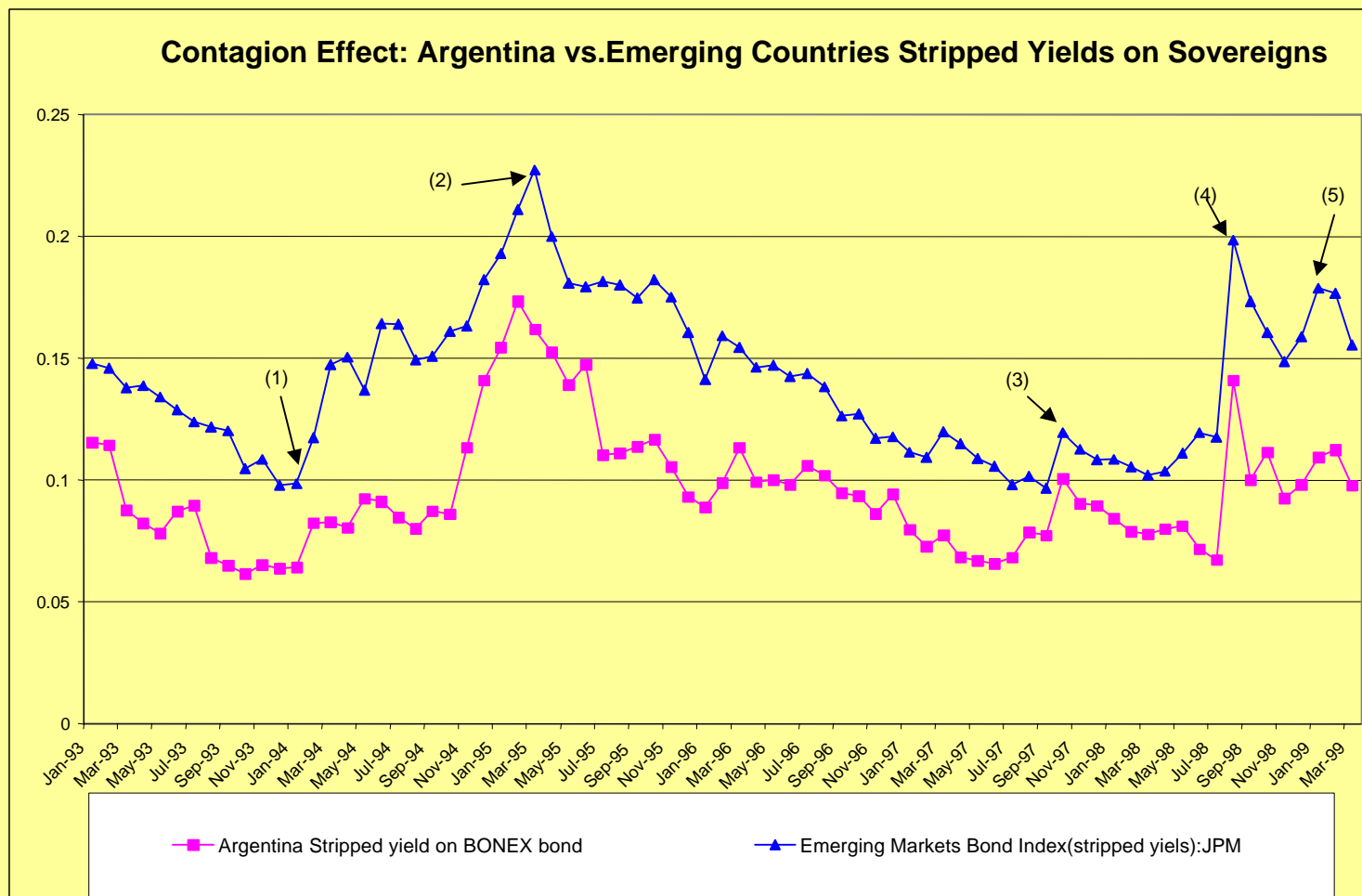
Default history (most important)

Level of development,

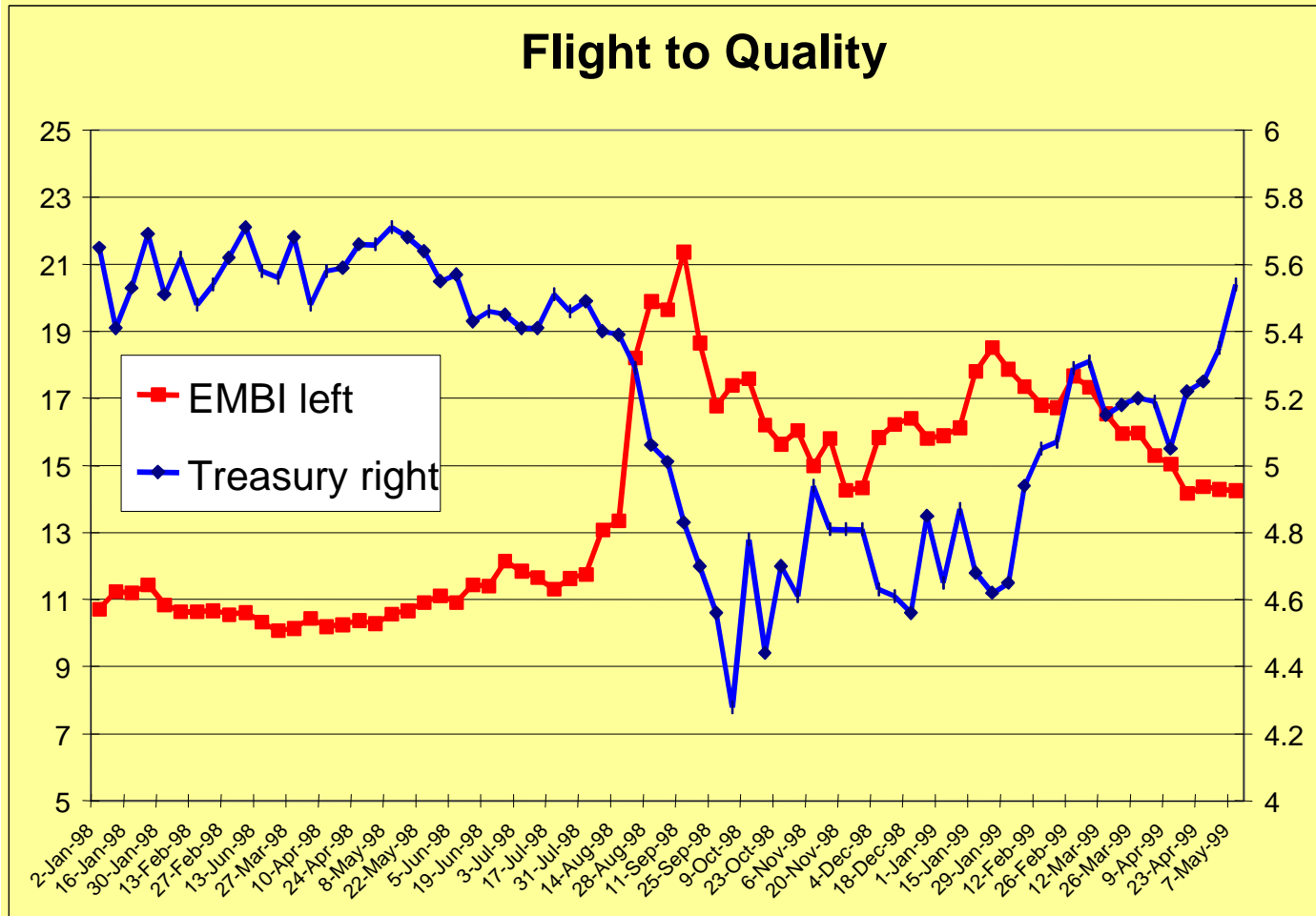
Fiscal deficit

Current account deficit

Contagion Effect: Markets tend to hold to memories of past performances and, in the absence or inability to process new information, they tend to rate a country by the performance of what they consider to be similar countries



As EC's become more risky, investors increase the demand for safe assets generating the **"flight to quality"**.



The "flight to quality" reduces the service cost of existing debt and the "contagion effect" raises the cost for increases in debt.

Source: Bloomberg's

Differentiation is the way to escape from Contagion

**Differentiation is a slow process : Credibility is built on
Fundamentals and Persistence
Markets are fast to downgrade but slow to upgrade.**

The most sought after fundamental is Fiscal Balance

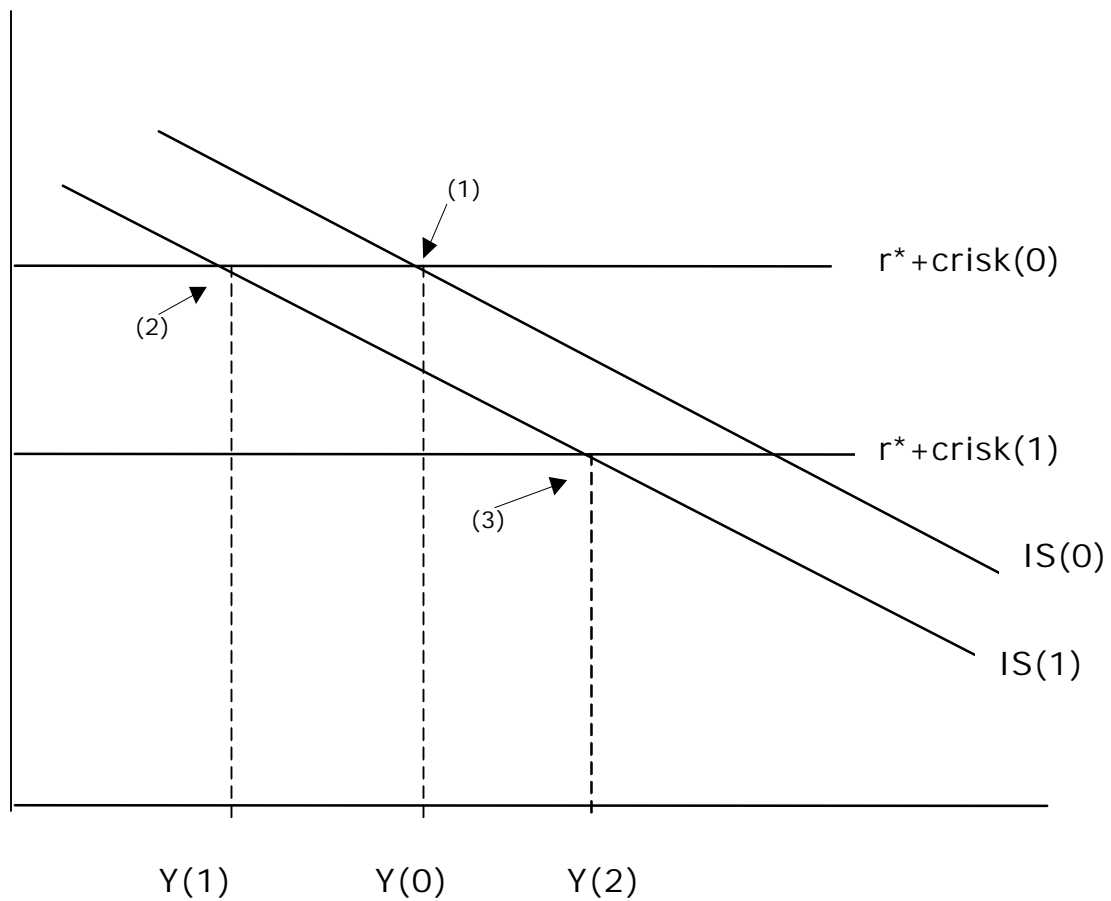
Unconventional view for Fiscal Surpluses:

The conventional view is that Fiscal Surpluses are contractive and deficits are expansive.

However, for a debtor country Fiscal Surpluses lower country risk and induce capital inflows that:

- Increase economic activity**
- Deteriorate the Current Account**
- Induce Real Appreciation**

Fiscal Policy and Country Risk



Is there a Country Specific Economic Policy?

**Rostow's mentioned four groups of countries:
DC's, LDC's, Japan and Argentina.**

Now we know that neither Japan nor Argentina are unexplained paradigms. Rather, their performances can be quite well explained using conventional economics tools.

Japan's growth has fallen every decade since the 1960's. The reason lies in the weakening of the financial system as a result of subsidizing the real sector.

Argentina showed it could grow and defeat inflation as soon as it embraced conventional ortodox macroeconomics.

The Argentine Convertibility Plan: 1991-1999

(1) Monetary Reform:

- Convertibility Law
- Independence of the Central bank
- Effective use of the Budget Law.

(2) Fiscal Reform

Use of Conventional Taxes instead of Inflation Tax

(3) State Reform: Privatization and Deregulation.

(4) Social Security Reform: Private sector run Capitalization System.

(5) Trade Reform:

- Elimination of export taxes and most QR's
- Creation of Mercosur and the Common External Tariff.

(6) Market Reform: Elimination of controls on prices, wages, interest rates and FOREX.

RESULTS	1982-88	1992-98
Annual GDP Growth:	1.1%	4.5%
Annual Inflation:	313.2%	2.3%
Unemployment (1988 and 98)	6.1%	12.4%

In spite of the important changes made, unemployment is high and the economy is still not competitive.

The main reasons for these failures are:

1- Incomplete deregulation of the labor market

2-Very high employment taxes

3-High Tax Evasion helped by high Nominal Tax rates that fall more on large enterprises

4-Lack of progress in much needed Institutional Reforms such as Revenue Sharing, Justice, Education and Health.

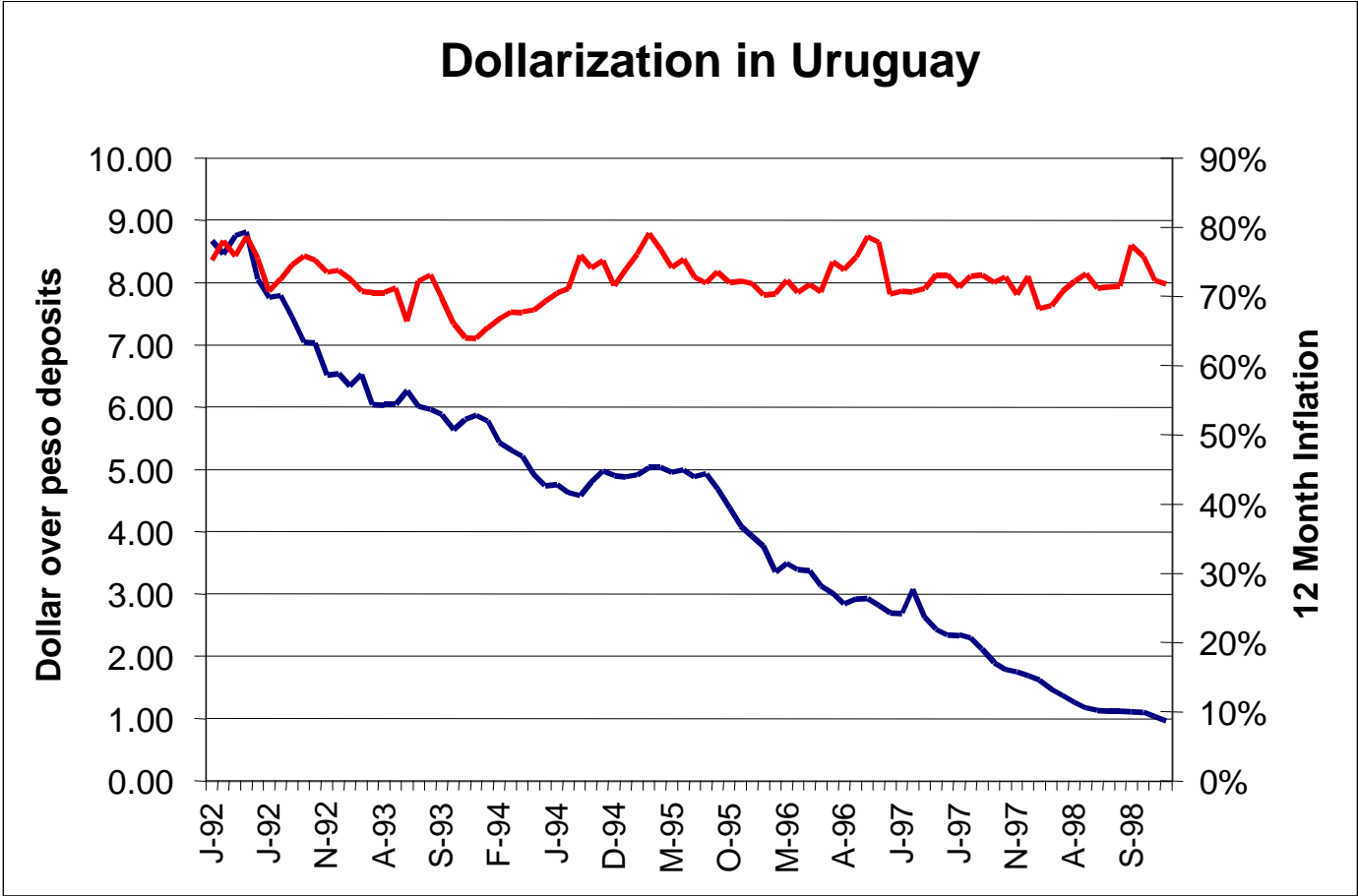
Dollarization

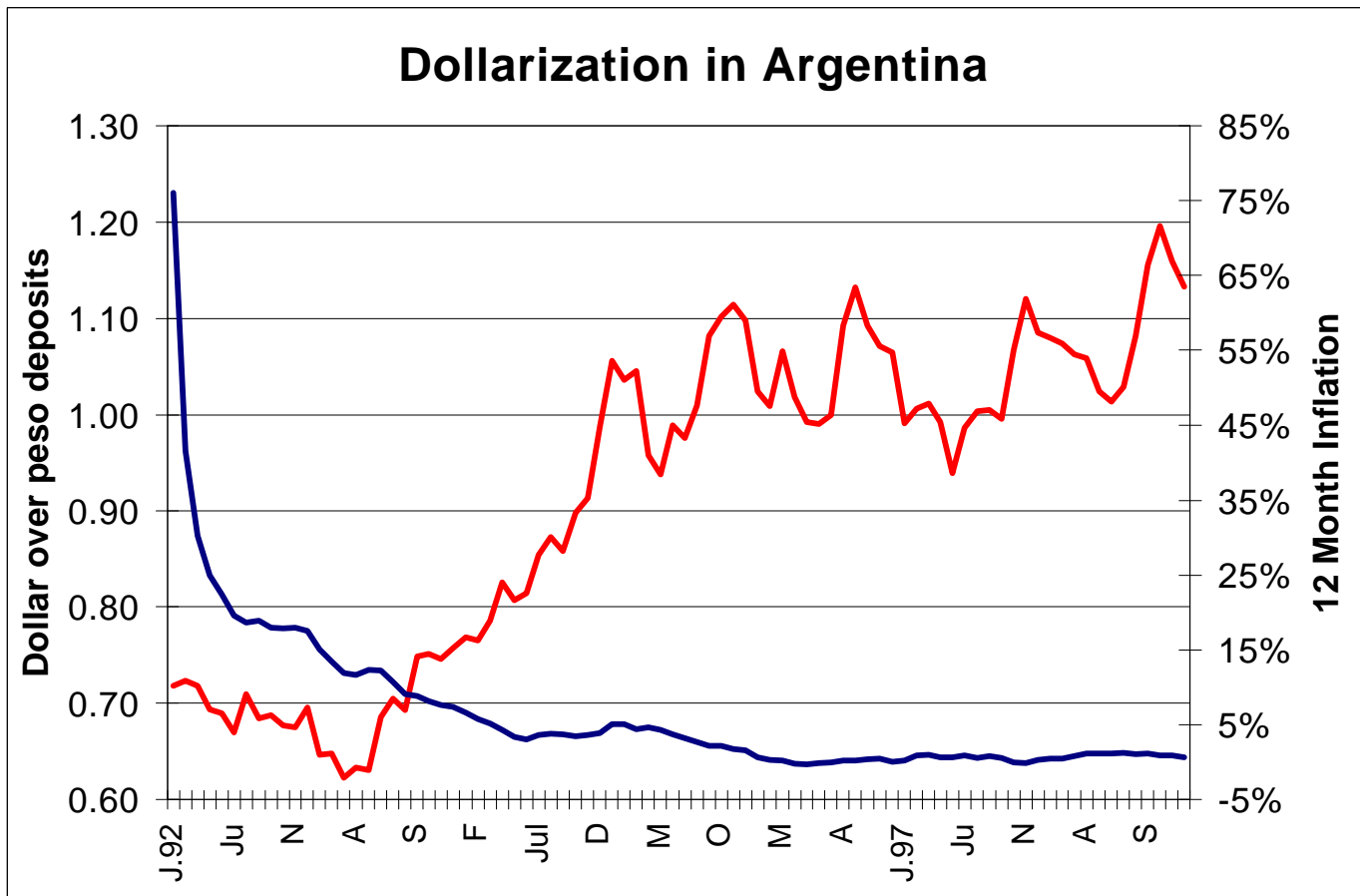
Dollarization appears as a hedge against high inflation and transitory increases in inflation may result in permanent changes in the degree of dollarization (hysteresis) (Guidotti and Rodríguez ,1992 Staff Papers)

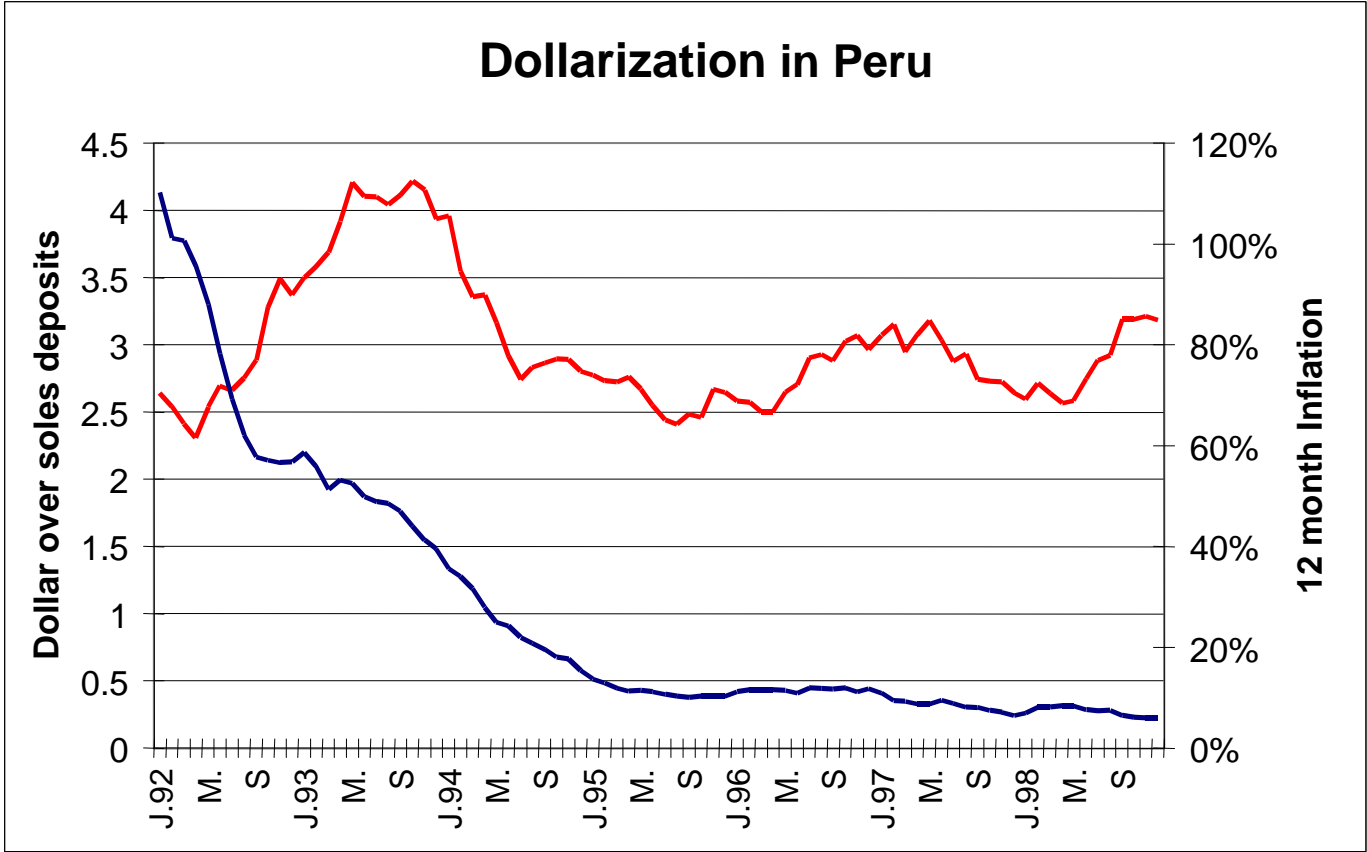
The Latin American experience shows that dollarization is **practically irreversible** in spite of significant and sustained reductions in inflation rates.

We think **monetary institutions should accommodate to dollarization**. The alternative is black markets, disappearance of credit and high real interest rates.

Dollarization in Uruguay







Devaluations: Can they Help?

There are two things devaluations surely do:

-Melt down domestic currency assets:

Reduce spending and induce CAcc. Surplus

-Generate panic:

Induce capital outflow and thus C.Acc.Surplus

Examples: Argentina 1981, Mexico 1994 and Brazil 1999.

Most devaluations are brought by a fiscal crisis:

The high real exchange rate is the result of the crisis and not an improvement in competitiveness.

Devaluation: Nominal and Real Effects Argentina 1972-1998

	Nominal W age	Nominal Exchange Rate *	Money Supply	W holesale Prices
1972	1	1	1	1
1980	852	452	1305	841
1998	34.831.460.674	33.087.800.382	107.047439.490	33.635.336.699
	Real W age	Real Exchange Rate	Real Cash Balances	
1972	1	1	1	
1980	1.01	0.54	1.55	
1998	1.04	0.98	3.18	

Paying Interest on Money

Make Money more attractive by remunerating reserve requirements or by forcing banks to hold government bonds.

The algebra of remunerated money:

$$dM/dt = Def + Inf.z.M$$

$$(1/M).dM/dt = (Def/M) + z.Inf$$

$$(1/M)dM/dt = Inf$$

$$Inf = (Def/M) + z.Inf$$

$$Inf = (Def/M)/(1-z)$$

As z tends to unity, the resulting inflation from any deficit tends to infinity.

The Olivera-Tanzi and Monetization Effects

If inflation falls tax collection increases (O-T effect) and demand for money raises.

No need to reduce deficit spending if the public believes that inflation will fall.

All that is needed is to announce a plan that says that inflation will fall.

The falacy is to assume the market expectations are based on announcements
and not on fundamentals.

**When all credibility has been lost, governments have
to back announcements with facts: Currency Boards.**