

**BALANCE OF PAYMENTS DOMINANCE:
ITS IMPLICATIONS FOR MACROECONOMIC POLICY**

José Antonio Ocampo *

Abstract

This paper defines “balance of payments dominance” as a macroeconomic regime in which the short-term macroeconomic dynamics is essentially determined by external shocks, positive or negative. It argues that this is the predominant regime in emerging and developing countries. Trade shocks play an important role but the major procyclical shocks are associated with boom-bust cycles in external financing. Policy challenges are associated not only with the management of such shocks but also with the need to enhance the space for countercyclical macroeconomic policies, as boom-bust cycles tend to pressure macroeconomic policies to behave in a procyclical way. Under these conditions, the best bet is to design policies to reduce *external* vulnerabilities through a mix of administered exchange rate policies, very active foreign exchange reserve management, reduced reliance on external borrowing, and macroprudential regulations, including those directly affecting capital flows. Countercyclical fiscal policy can also play a role but face strong economic and political economy challenges.

A major theme of structuralist economics has been the central role that the balance of payments plays in macroeconomic dynamics (Ocampo, Rada and Taylor, 2009). The emphasis on the implications of “external gaps” and the “Dutch disease” for growth in developing countries are part of that tradition. According to Bresser-Pereira’s (2009) formulation, in economies with heavy comparative advantages in the production of commodities, the latter is associated with the existence of two equilibrium exchange rates: one for the balance of payments with specialization in natural resources and one for dynamic diversification into manufacturing. However, in this paper I will refer to a different phenomenon: the heavy influence that the balance of payments exercises on *short-term* macroeconomic dynamics –i.e., the dependence of domestic business cycles on external shocks, positive and negative, that are transmitted through the balance of payments. One of the major features of this dependence is that it also generates strong pressures for macroeconomic policy to behave in a procyclical way.

* Professor at the School of International and Public Affairs and Fellow of the Committee on Global Thought at Columbia University. Formerly Under-Secretary General of the United Nations for Economic and Social Affairs, Executive Secretary of the Economic Commission for Latin America and the Caribbean, and Minister of Finance of Colombia.

The close link between external and domestic business cycles in developing countries has old roots. It was evident during the days of the gold (and silver) standard, when countries of the periphery were frequently forced to abandon it during crises. However, the aim was always to return to such standards and the associated “rules of the game”, which essentially meant procyclical macroeconomic policies. The final collapse of the gold standard during Great Depression represented a huge paradigm change, as Keynesian policy shifted the attention of macroeconomics to countercyclical policies. However, while the center of attention of such policies in the industrial countries came to be the management of aggregate *demand* through active fiscal and monetary policies, the predominance of external shocks implied that the focus of countercyclical management in developing countries came to be the management of the *supply* shocks associated with the availability of foreign exchange.

The mainstream literature has called “fiscal dominance” a regime in which macroeconomic management is essentially determined by fiscal conditions. So, I will call “balance of payments dominance” the regime in which the external shocks, positive and negative, are the essential determinant of short-term macroeconomic dynamics. Under this regime, the balance of payments exercises strong *procyclical* shocks, through the trade account, the availability of external financing, movements in interest rates (reductions in risk spreads during booms, increases during booms) that have procyclical impacts, and cyclical effects on exchange rates (appreciation during booms, depreciation during crises) that have more ambiguous effects. Under these conditions, macroeconomic authorities have to fight hard to build the space for effective countercyclical macroeconomic policies.

It is thus not surprising that in the old days of state-led industrialization, the major instruments of macroeconomic policy focused on managing external shocks, mainly those coming through the trade account but, since the 1970s, also from the capital account. The interventionist apparatus included an array of instruments of protection and export promotion, capital controls, multiple exchange rates (particularly in the early years) and since the 1960s the crawling peg, a major innovation to manage the exchange rates in inflation-prone Latin American economies (Frenkel and Rapetti, 2011). Most of

these instruments were dismantled during the process of economic liberalization. The major one left was the exchange rate, which was made increasingly flexible to accommodate the external shocks that came through the capital account.

This paper will explore the nature and modalities of countercyclical macroeconomic policies under balance of payments dominance. In the next section, I deal with the contemporary modalities of this dominance. Then I discuss countercyclical fiscal policies and the space for monetary and exchange rate autonomy in economies subject to such regime. The paper is mixed with references to the Latin American experience.

The contemporary modalities of balance of payments dominance

International trade continues to generate procyclical shocks for developing countries.¹ This is particularly true of terms of trade shocks in commodity dependent economies. The recent crisis also showed in a dramatic way how the economies specializing in manufacturing and services can be subject to procyclical external demand shocks. More generally, it is increasingly clear that international trade generates procyclical effects on most economies.

However, the dominant feature since the mid-1970s has been the central role that the *capital* account plays in generating procyclical shocks for those developing countries that have access to private capital markets –i.e., “emerging economies” (a variable but increasing group). Furthermore, whereas fiscal accounts played a central role in the first contemporary cycle of external financing (from the mid-1970s through the traumatic 1980s), the dominant feature in recent decades has been the predominance of external private financing and the procyclical effect they have on *private* sector spending and balance sheets. One of its manifestations has been the frequency of “twin” domestic banking and external crises since the early 1980s, with the liberalizing Southern Cone countries of South America as pioneers in this field.

¹ I include here the so-called “emerging economies”, a category that has an unclear definition but will be understood here as those economies that have access to global private capital markets.

This phenomenon is, of course, part of the basic tendency of private finance to experience boom-bust cycles, a theme that was central to the Keynesian revolution and was developed with particular sharp terms by Minsky (1982). Confirmation of this pattern is provided, among others, in the classic analysis of Kindleberger (see Kindleberger and Aliber, 2005) and the most recent book by Reinhart and Rogoff (2009) and, in relation to emerging economies and Latin America by Ffrench-Davis and Griffith-Jones (2011). Through the business cycle, private agents alternate between “risk appetite” (or, rather, underestimation of risks) and “flight to quality” (risk aversion), to use typical terms of the financial parlance. In turn, opinions and expectations of different agents feed back into each other, generating an alternation of contagion of optimism and of pessimism. Asymmetries of information typical of financial markets, risk evaluation models and certain market practices (benchmarking with competitors) tend to accentuate these trends.

Boom-bust cycles are stronger for those agents that are considered riskier by financial markets, who experience availability of finance during booms followed by credit rationing and/or high costs of financing during crises. This the situation faced by small enterprises and lower income households even in mature industrial markets. It is also the situation of emerging and developing countries during crises (including, during the current one, peripheral Europe). One way of understanding this phenomenon is that financial integration by developing countries into the global financial market is a segmented integration (Frenkel, 2008) –i.e., integration into a market that is segmented by risk categories, with those considered riskier being subject to deeper boom-bust cycles. As a result, emerging economies experience boom-bust cycles independently of macroeconomic fundamentals (Calvo and Talvi, 2008). Countries that are considered “successful” are inevitably brought into the boom, but this can lead to the accumulation of vulnerabilities that may lead to them to crises; if so, they may later turn into pariahs (Ffrench-Davis, 2001; Marfán, 2005).

Volatility is reflected in the behavior of spreads as well as in the availability and maturity of financing, all of them with procyclical effects. Risks tend to be more pronounced in developing countries due the proliferation of maturity and currency

mismatches in private balance sheets. All forms of financing tend to be procyclical, but this pattern is sharper for short-term financing, which thus tends to be particularly risky (Rodrik and Velasco, 2000). The most recent diagnosis by the IMF (2011, ch. 4) indicate that volatility has increased over time and is sharper for emerging than for advanced economies. Bank and other capital flows are more volatile, followed by portfolio debt flows, but FDI volatility has increased and is now similar than that for portfolio debt flows. In turn, persistence is lowest for portfolio debt flows, and has declined for FDI since 2000. In the case of FDI, increasing volatility and lack of persistence may reflect the fact that financial FDI (i.e., borrowing by subsidiary from a parent bank or firm) has increased over time.

Intense short-term movement, such as those produced after the August 1998 Russian moratoria and the September 2008 collapse of Lehman Brothers, are particularly traumatic. However, in practice the most difficult phenomena to manage in macroeconomic terms are *medium-term* cycles. Developing countries have experienced three such cycles since the 1970s and are at the beginning of a fourth one: a boom in the second half of the 1970s followed by collapse in the 1980s; boom in 1990-97 (shortly interrupted by the December 1994 Mexican crisis) followed by the sequence of emerging market crisis that started in East Asia in mid-1997; a new boom between 2003 and mid-2008 followed by the global effects of the collapse of Lehman Brothers; and a new boom since mid-2009.

Historical evidence seems to indicate that the intensity of policies adopted by advanced economies to stabilize financial markets is critical for the length of the downward phase of the cycle. So, the massive interventions after the collapse of Lehman brothers were critical for the return to more normal financial conditions in a relatively short time period (about a year). The same is true of massive support to Mexico after its December 1994 crisis (a few months). In contrast, weak and delayed action after the August 1982 Mexican moratoria and the first stages of the East Asian crisis in the second semester of 1997 lead to protracted crises in emerging markets (eight and six years, respectively).

Another factor that has mitigated the strength and length of crises is the reduced *external* vulnerability of developing countries generated by the combination of massive self-insurance through foreign reserve accumulation and the development of domestic bond markets in emerging economies after the Asian financial crisis, which made governments less dependent on external financing. Both led to the reduced perception of risk, reflected in the low spreads between 2004 and 2007. Although this may be understood as a reflection of reduced market segmentation, the fact that its counterpart is massive self-insurance indicates that market segmentation is still a feature of the global economy, but one that can be mitigated by prudential policies.

As indicated, the major problems generated by boom-bust cycles are associated with procyclical private sector spending and induced vulnerabilities in balance sheets. However, the major complication is that this is accompanied by the reduced space for traditional countercyclical policies. Given this constraint, the key to appropriate countercyclical management is the expanded availability of policy instruments to manage the domestic effects of external boom-bust cycles. This is particularly so when we understand that stability goes beyond price stability and includes *real* and *financial* stability –i.e., avoiding sharp business cycles and domestic financial crises. In this regard, Latin America has increased price stability and experienced for the first time an external bust that did not lead to any domestic financial meltdown. However, it has advanced much less in terms of avoiding *real* instability. Indeed, the sharp slowdown experienced during the recent global financial crisis was the worst since the early 1980s and second in the emerging and developing world to that of Central and Eastern Europe (Ocampo, 2011), though the recovery was strong, facilitated by the rapid stabilization of external financing and commodity markets.

This indicates the need to continue reflecting on the design of countercyclical policies appropriate for economies facing balance of payments dominance. In the rest of the paper I will explore three broad set of policies and their capacity to smooth the business cycle: fiscal policies; monetary and exchange rate policies (that due to their linkages must be analyzed simultaneously), and capital management techniques (Epstein

et al., 2003; Ocampo, 2008), which using the terminology en vogue will be called macroprudential policies.

Countercyclical fiscal policies

Fiscal policy can always play a useful countercyclical role, but it faces strong pressures to operate in the opposite way due to the pressures from financial markets and political economy considerations. In countries where commodity prices are an essential source of public sector revenues, one of the best alternatives is to create commodity stabilization funds. The most important examples in Latin America are the National Coffee Fund of Colombia (which, however, largely abandoned its stabilization function in the 1990s) and the Chilean copper stabilization funds, but this instrument has spread worldwide, in particular in mineral and oil-exporting economies. Based on this experience, ECLAC (1998) proposed creating general stabilization funds for public sector revenues which would absorb the transitory component of such revenues.

This should be accompanied by the creation of structural rules for public sector financing, a step taken a decade ago by Chile and being replicated by other Latin American countries. This is, of course, no easy task, as GDP trends may not be independent from cyclical fluctuations, particularly in economies experiencing sharp business cycles (Heyman, 2000) and in commodity dependent economies because commodity prices may be subject to random walks –i.e., short-term fluctuations that may lead to permanent changes in trends. In any case, what the structural rules imply is that public sector finances must be guided by long-term trends. Strictly speaking, what this means is that fiscal policy becomes *neutral* over the business cycle (i.e., *a*-cyclical), implying that it has to be complemented by strictly countercyclical instruments.² However, to avoid lags in the countercyclical effects of fiscal policy, the best are automatic stabilizers associated with tax and spending policies.

In this regard, the experience of industrial economies is that the best automatic spending stabilizers are those associated with social protection systems, particularly unemployment insurance. The latter may not be the appropriate instrument in developing

² See Ffrench-Davis (2010) in relation to the Chilean fiscal funds.

countries, where informal jobs play an important role in employment generation. Some additional instruments may be needed, particularly emergency employment programs that are automatically triggered during crises. Conditional cash transfers were also used during the recent crisis for this purpose in several countries; however, as it is hard to reduce them during upswings, it cannot be used as a permanent countercyclical tool.

Tax instruments can also play the role of automatic stabilizers. The best case is, of course, a progressive income tax. However, other tax instruments can play that purpose. This can be the case of instruments to capture windfall price gains in natural resource exports that are absorbed through the aforementioned commodity stabilization funds. A similar argument can be made to tax capital inflows during capital account booms. Note that this is a fiscal argument for the use of this tax, and thus different to those that will be discussed in the next section, which relate to monetary and foreign exchange management. With a similar logic, a countercyclical VAT could be designed. An alternative used by some countries during the recent crisis was to temporarily reduce some VAT rates to encourage spending.

Countercyclical fiscal purposes face, in any case, some constraints, of both economic and political economy character. In economic terms, the major problem is lack of access to appropriate financing during crises, as well as the pressure from markets (and possibly the IMF) to adopt austerity policies to generate “credibility” –i.e., reduce the perceived risk of default. However, if authorities adopt austerity policies during crises, it would be politically impossible to justify maintaining those policies during booms. Thus, austerity during crises generates a vicious circle that leads to the pressure to spend during the succeeding boom, thus generating a procyclical fiscal policy.

In turn, during booms, it is difficult in political terms to justify fiscal austerity to compensate for the “exuberance” of private sector spending (Marfán, 2005). This is particularly true if the spending boom benefits high income groups and cuts in public sector spending affect lower income recipients, as countercyclical fiscal policy would be regarded as regressive in distributive terms. There may be also classical time inconsistency issues. Particularly, savings during booms may generate pressure to spend

them (the pressure Chile face during the previous boom) or to dilapidate them in the form of unsustainable tax cuts (what the US did after the Clinton era).

Countercyclical fiscal policy can also generate some inefficiencies in public sector spending (for example, interruptions in public sector investment projects that increase their costs) or long-term inflexibilities (additional social spending during crises that becomes permanent). Furthermore, in political terms, it may be difficult to design countercyclical tax instruments, as reflected in the opposition of commodity exporters to taxes that capture their windfall gains.

For all these reasons, countercyclical fiscal policies are the exception rather than the rule in the developing world. The analysis of cyclical patterns of spending in over 100 countries during 1960-2003 by Kamisky *et al.* (2004) indicates, in fact, that fiscal policies tend to be procyclical in developing countries, particularly in Africa and Latin America, in contrast to the experience of the industrial world. Using these results, Ocampo and Vos (2008, ch. IV) showed that this procyclical pattern is associated with lower long-term growth. For Latin America, Martner and Tromben (2003) come to similar conclusions regarding the dominance of procyclical fiscal in Latin America in 1990-2001 and Bello and Jiménez (2008) for 1990-2006.

Contrary to a common perception, this continued to be the case during the recent cycle (the 2003-2008 boom and the 2009 crisis).³ Procyclical policies were the rule in most countries, and a few showed persistent expansionary spending policies, which implied that they were procyclical during the boom, but in a sense turned countercyclical during the crisis. Strict countercyclical policies were followed by only a handful of countries. In fact, a good description of Latin American fiscal patterns over the last two cycles is one in which spending respond with lags to revenues through the business cycle (Ocampo, 2011). So, spending was moderate during the initial phases of the recent boom but turned very expansionary at the end (2006-08) –i.e., highly procyclical. This spending dynamics was maintained during 2009, thus generating some countercyclical effects. The

³ See, among others, IDB (2008) and Ocampo (2009) for the boom, and IMF (2010, ch. 4) and Ocampo (2011) for the recent cycle as a whole.

return to greater austerity in 2010 was the result of the lagged response to lower revenues, but generated a countercyclical effect given the speedy recovery that took place.

Thus, despite advances in fiscal discipline, which in fact have lasted for more than two decades and can be considered a legacy of the debt crisis, and the more recent reduction in public sector debt ratios, much remains to be done to design truly countercyclical fiscal policies.

Monetary and exchange rate autonomy under balance of payments dominance

The history of the global economy in recent decades is full of examples of the strong procyclical pressures that boom-bust cycles in global capital markets exercise on monetary and exchange rate policies in developing and, particularly, emerging economies. This is particularly true of monetary policy in economies that have opened their capital account, and that face strong pressures to reduce interest rates during booms and increase them during crises, following trends in international capital markets. If authorities try to counteract these pressures and manage monetary policy in a countercyclical way, they simply displace the effect towards the foreign exchange market –i.e., they speed up appreciation pressures during booms and depreciation pressures during crises. What this means is that authorities in fact lack policy autonomy and can only choose what procyclical effect from global capital markets they prefer.⁴ This statement must be read in a nuanced way but captures a significant grain of truth.

The effects of exchange rate fluctuations are the most complex, as they generate ambiguous short-term effects, though clearly counterproductive long-term impacts. The major countercyclical effect operates through the current account of the balance of payments, as exchange rate fluctuations lead to a deterioration of the current account during booms and improve it during crises, thus helping stabilize aggregate demand fluctuations. However, beyond certain level, these countercyclical effects are actually counterproductive, as there is broad evidence that deterioration in the current account

⁴ There is some similarity here with the view of Robert Mundell regarding monetary policies under a fixed exchange rate regime. According to his now classical view, authorities do not determine the money supply but can change the composition of domestic and foreign exchange assets that the central bank holds.

during booms has been a common source of crises: it helps to “absorb” the excess supply of external financing during booms but turns into the major vulnerability during crises when capital stops flowing in. In turn, the associated exchange rate volatility generates unstable incentives to invest in the production of tradable goods and services, which are particularly counterproductive in terms of the diversification of the export base. For these reasons, structuralist macroeconomics has taken a negative view of this countercyclical effect of exchange rate movements.⁵

Furthermore, these effects tend to be frequently weaker than the procyclical effects that exchange rate fluctuations also generate, through two different channels, and that explain the ambiguous effects that exchange rate fluctuations have over aggregate demand through the business cycle. The first and most important are the effects that exchange rate fluctuations have on private sector balance sheets in economies where the private sector is a net borrower in international capital markets.⁶ In this case, appreciation during booms generates capital gains that tend to increase aggregate demand, whereas depreciation during crises generates capital losses and recessionary effects. The second effect are of a distributive character and have been analyzed by the traditional literature on the contractionary effects of devaluation (Diaz-Alejandro, 1988, ch. 1; Krugman and Taylor, 1978). The simplest way of visualizing them is through the effects of the exchange rate of real wages: appreciation tends to increase real wages, thus generating an expansionary effect if there is a high propensity to consume wage incomes, whereas depreciation during crises generates the opposite effect during crises.

The macroeconomic literature has captured the constraints that macroeconomic authorities face through what has come to known as the “trilemma” of open economies. Its most important implication is that in countries where the capital account has been opened up, authorities can control the exchange rate or the interest rate, but not both of them. Prior to the crisis, this led several economists to argue that there is a need for “credible” exchange rate regimes, which in their view should either be entirely flexible

⁵ See, for example, Frenkel (2007), Ocampo (2003 and 2008), Ocampo, Rada and Taylor (2009) and Stiglitz *et al.* (2006).

⁶ This may also be true of public sector balance sheets, but those effects can be accommodated in a properly designed countercyclical fiscal policy.

exchange rates –in which they maintain monetary policy autonomy but give up the management of exchange rates altogether—or “hard” pegs. In the latter case, they really give up both monetary and exchange rate autonomy; indeed, this system is the modern counterpart of the procyclical “rules of the game” of the gold standard. The system is meant to avoid the destabilizing speculative flows typical of fixed but adjustable rates. However, from historical experience, we know that such destabilizing flows may not be absent and indeed that the collapse of such regimes is chaotic, as it was shown by the crumbling of the gold standard during the 1930s, and by the disorderly breakdown of the Argentinean convertibility regime in the early 2000s.

In contrast, the choice of flexible exchange rates with monetary policies aimed at meeting inflation targets has some countercyclical virtues. Nonetheless, this is true if and only if aggregate domestic demand is the major determinant of inflation.⁷ However, as already shown, under balance of payments dominance, exchange rate variations can have procyclical effects on aggregate demand. Furthermore, the supply shocks (positive or negative) that exchange rates have on domestic prices run in the opposite direction to those assumed by the inflation targeting regime, and may lead to procyclical policy decisions. Thus, if appreciation reduces the price level during booms, interest rates may not be adjusted in the required magnitude to cool domestic demand; in contrast, the inflationary effect of depreciation may lead to a suboptimal increase in domestic interest rates during crises to cool domestic price inflation. It is not surprising that the theoretical analysis of inflation targeting in open economies has indicated that a strict inflation targeting regime tends to increase real economic volatility (Svensson, 2000).

A “flexible” inflation targeting regime, which takes into account also real volatility, can correct in part these problems. However, the foundations of inflation targeting tend to weaken considerably under balance of payments dominance due to the fact that aggregate demand and the domestic price level have strong external determinants. As traditional structuralist price analysis indicates, this may be complicated by indexation mechanisms. Inflation targeting also assumes that demand is sensitive to

⁷ This reflects the case which the orthodox literature has called the “divine coincidence” that by meeting the inflation targets authorities are able to keep economies at full employment. However, such outstanding result has been absent even in industrial economies.

interest rates, and that the interest rate set by central bank affect the overall structure of interest rates in the economy; both assumptions may be inappropriate in many (if not most) developing countries with inadequately developed domestic financial systems.

For all these reasons, inflation targeting should be replaced by rules that accept that central banks must have multiple objectives. In developing countries, such objectives should be at least three: inflation, economic activity (employment) and the exchange rate.⁸ Today there is also broad agreement that financial stability should be added as a major objective, as independently of whether central banks are the regulatory authority, financial stability has clear macroeconomic dimensions. This does not mean that inflation should be a secondary objective, subordinated or contingent to achieving other objectives; in economies, such as those of Latin America, which have been prone to inflation, it should be a major one.

Obviously, an alternative reading of the “trilemma” is that what has to be given up is capital account liberalization. Furthermore, the multiplicity of objectives that monetary authorities should have implies that central banks should actively search for *more instruments*.⁹ This is reinforced by the fact that the effectiveness of each individual instrument may be limited, a fact that implies that the number of instruments should possibly exceed the number of objectives. This is, in a sense, the essential lesson of macroeconomic management in open economies: the cost of rejecting the use of some instruments is high in economies subject to balance of payments dominance. The trade and capital account liberalization process led countries to give up many instruments used in the past to manage external shocks without creating new ones. Furthermore, given the fact that interest rate shocks faced by these economies are procyclical, attempting to counteract such pressures implies that an excessive burden was placed on the exchange rate, which does not always play a countercyclical role.

In the face of these dilemmas, many authorities in emerging and developing countries have pragmatically come to the conclusion, not only that polar exchange rate

⁸ It is interesting to recall that in the US Federal Reserve System, the exchange rate is not an objective, but monetary authorities have three objectives: “maximum” employment, inflation and moderate long-term interest rates.

⁹ This is a central message of one of Stiglitz’s well known essays (Stiglitz, 1998).

regimes are inappropriate but that they must use a broader set of instruments to manage the challenges typical of balance of payments dominance. The two favorite instruments have been a more active use of countercyclical variations in foreign exchange reserves, appropriately sterilized, and a return to some form of capital account regulations. Both can be clearly used in a countercyclical way and explain why the emerging foreign exchange rate regimes are “intermediate” cases of *administered* exchange rate flexibility—and in several countries, highly administered flexibility. On top of this, a new layer of countercyclical instruments to manage prudential regulation have been added. These instruments, together with those associated with the administration of the capital account have come to be covered under the “macroprudential perspective”. Interestingly, some analysts include also under this concept some traditional instruments of monetary management that were widely used in the past—particularly reserve requirements on bank deposits—and that several countries had started to use again even before the crisis.¹⁰

The essential advantage of active foreign exchange reserve management is that it allows, within certain limits, to simultaneously control interest and exchange rates (see, in this regard, Frenkel, 2007). During booms, this requires sterilized accumulation of foreign exchange reserves, which then operates as “self-insurance”, enhancing the policy space for a macroeconomic management during the succeeding crisis. Foreign exchange reserve management also helps smooth out the effects of capital flows on exchange rates and thus the unstable incentives that it generates on the production of tradables. Obviously, sterilized interventions are costly: at the national level, they generate losses if the return on the investment of reserves is lower than the costs of capital inflows (which it generally is); for central banks, there may also be losses if the instruments of sterilization are costlier than returns on reserves, including capital gains and losses made on foreign exchange management through the business cycle (which may be a less important problem in economies with low domestic interest rates).

These costs imply that there may be significant benefits in avoiding excess capital inflows in the first place. The term “control” is generally used to refer to interventions in

¹⁰ See in this regard IMF (2010, ch. 3). However, it is useful to differentiate clearly between instruments of monetary and prudential regulation.

the capital account, rather than the most appropriate concept of “regulation”. Indeed, regulations on capital flows are of a similar nature to other types of regulations: they may be quantitative in character (e.g., prohibitions) or price-based (e.g., reserve requirements on capital inflows). Furthermore, those focused on avoiding excess capital inflows are clearly *prudential* in character, as they aim at correcting the risks associated with such excess inflows.

Capital account regulations operate in two ways: they improve the liability structure of countries, making them less vulnerable to the greater volatility that characterizes certain flows, and they provide larger space for countercyclical monetary policy. In this sense, they enhance macroeconomic policy autonomy. In any case, the literature on this issue indicates that the effects of capital account regulations may be limited and temporary.¹¹ This does not mean that they should not be used. Rather, it means that they should be used in the magnitude necessary to be effective, and dynamically adjusted to compensate for the tendency of financial markets to elude them. In any case, since mechanisms used to evade regulations are costly, they show that regulations are at least partly effective. Among new instruments that can be designed, an attractive one is a reserve requirement on foreign exchange *liabilities* of both financial and non-financial agents, which may substitute the traditional reserve requirement on capital inflows. This would also make this instrument more similar to traditional instruments of monetary and prudential regulation, which operate on stocks rather than flows.

The use of capital account regulations with a countercyclical focus can be complemented with domestic prudential regulations, as was suggested by the Bank of International Settlements and ECLAC over a decade ago and was practiced by Spain since 2000.¹² The recent global financial crisis finally inclined authorities to lean towards these instruments. The modality adopted by the Basle Committee in 2010 uses capital as the main countercyclical instrument, but it can be complemented with the countercyclical use of loan loss provisions (the Spanish system) and liquidity requirements, as well as

¹¹ See, for example, Ocampo (2008) and Ostry *et al.* (2010).

¹² See the review of the debate on this issue in Griffith-Jones and Ocampo (2010) and of the Spanish experience in Saurina (2009).

those aimed at moderating the procyclical effects of asset price fluctuations, among others. In emerging and developing countries, an essential ingredient of those regulations must be the management of currency mismatches in portfolios, which tend to generate substantial risks and are one of the basic reasons for the procyclical effects that exchange rate fluctuations may have. Tax provisions can also be used for this purpose, particularly by changing the tax treatment of the external debt service, as suggested by Stiglitz and Battarcharya (2000).

The recent empirical literature comes overwhelmingly in favor of the view that the reduced *external* vulnerability was the major reason for the fair performance of developing countries during the recent global financial crises. Depending on the study, the reduced external vulnerability is associated empirically with a mix of five different factors: (i) lower current account deficits; (ii) competitive exchange rates; (iii) high level of foreign exchange reserves; (iv) reduced short-term external liabilities; and (v) capital account regulations in place.¹³ This confirms the view that balance of payments dominance is a major issue that developing countries must learn to manage to improve short-term macroeconomic performance. Other factors, such as strong fiscal accounts (where there are major exceptions, including India) and autonomous central banks following inflation targeting rules are less important. Some level of exchange rate flexibility is part of the story, particularly in medium and large-sized developing countries, but as extensively argued above, an administered regime in which flexibility is mixed with active countercyclical management of foreign exchange reserves is a better alternative.

Improvements in external vulnerability are also the clue to recent improvements in Latin America's performance. The major gain during the 2003-08 boom was the mix of more active foreign exchange management, particularly the accumulation of foreign exchange reserves during phases of booming external financing (mid-2006 to mid-2007 and first semester of 2008) and the reduced reliance of public sectors on external financing thanks to the active development of domestic bond markets. Healthier fiscal

¹³ See, among many others, Frankel and Saravelos (2010), Frenkel (2010), Llaudes *et al.* (2010) and Ostry *et al.* (2010).

account had been in place since the 1990s but did not help avoid the crisis later in the decade (as lower inflation rates did not, either) and countercyclical fiscal policies continued to be the exception rather than the rule through the 2000s. Countercyclical monetary policies were also rare prior to the spike of food prices in 2008, though they were actively used during the crisis by most countries. Moderation of aggregate demand growth was not a feature of the boom either, as most countries actually experienced deterioration in current accounts adjusted by the terms of trade (Ocampo, 2009).

Conclusions

This paper defines “balance of payments dominance” as a macroeconomic regime in which the short-term macroeconomic dynamics is essentially determined by external shocks, positive or negative. It argues that this is the predominant regime in emerging and developing countries. Trade shocks play an important role but the major procyclical shocks are associated with boom-bust cycles in external financing. Policy challenges are associated not only with the management of such shocks but also with the need to enhance the space for countercyclical macroeconomic policies, as boom-bust cycles tend to pressure macroeconomic policies to behave in a procyclical way. Countercyclical fiscal policies can play a role but face strong economic and political economy constraints, which explain why fiscal policies tend to be generally procyclical. The best bet is to design policies to reduced *external* vulnerabilities through a mix of administered exchange rate flexibility, very active foreign exchange reserve management, reduced reliance on external borrowing, and macroprudential regulations, including those directly affecting capital flows.

References

- Bello, Omar and Juan Pablo Jiménez (2008), “Política fiscal y ciclo económico en América Latina”, División de Desarrollo Económico, CEPAL.
- Bresser-Pereira, Luiz Carlos (2009), *Globalization and Competition*, Cambridge: Cambridge University Press.
- Calvo, Guillermo and Ernesto Talvi (2008), “Sudden Stop, Financial Factors and Economic Collapse: A View from the Latin American Frontlines”, en Narcis Serra y Joseph E. Stiglitz (eds.), *The Washington Consensus Reconsidered: Towards a New Global Governance*, New York: Oxford University Press.

- Díaz-Alejandro, Carlos F. (1988), *Trade, Development and the World Economy: Selected Essays*, edited by Andrés Velasco, Oxford: Basil Blackwell.
- ECLAC (United Nations Economic Commission for Latin America and the Caribbean) (1998), *El pacto fiscal: fortalezas, debilidades, desafíos*, Santiago, serie Libros de la CEPAL, No. 47.
- Epstein, Gerald, Ilene Grabel and K.S. Jomo (2003). “Capital Management Techniques in Developing Countries”, in Ariel Buira (ed.), *Challenges to the World Bank and the IMF: Developing Country Perspectives*, Londres: Anthem Press, Chapter 6.
- Frankel, Jeffrey and George Saravelos (2010), “Are Leading Indicators of Financial Crises Useful for Assessing Country Vulnerability? Evidence from the 2008-2009 Global Crisis”, *NBER Working Paper 16047*, June.
- Ffrench-Davis, Ricardo (2001), *Financial Crises in ‘Successful’ Emerging Economies*. Washington, D.C.: Brookings Institution Press and ECLAC.
- _____ and Stephany Griffith-Jones (2011), “Taming Capital Account Shocks: Managing Booms and Busts”, in José Antonio Ocampo and Jaime Ros (eds.), *Handbook of Latin American Economics*, New York: Oxford University Press, Chapter 7.
- Frenkel, Roberto (2007), “La sostenibilidad de la política de esterilización monetaria”, *Revista de la CEPAL*, No. 93, Decembre.
- _____ (2008), “From the Boom in Capital Inflows to Financial Traps”, en José Antonio Ocampo y Joseph E. Stiglitz (eds.), *Capital Market Liberalization and Development*, New York: Oxford University Press, Chapter 4.
- _____ and Martin Rapetti (2011), “Exchange Rate Regimes in Latin America”, in José Antonio Ocampo and Jaime Ros (eds.), *Handbook of Latin American Economics*, New York: Oxford University Press, Chapter 8.
- Griffith-Jones, Stephany and José Antonio Ocampo (2010), “Building on the Counter-Cyclical Consensus: A Policy Agenda”, Group of 24, Research Papers, available at: <http://www.g24.org/research.htm>
- Heymann, Daniel (2000), “Grandes perturbaciones macroeconómicas, expectativas y respuestas de política”, *Revista de la CEPAL*, No. 80, April.
- IDB (Inter-American Development Bank) (2008), *All that glitters may not be gold: Assessing Latin America’s recent macroeconomic performance*, Washington, April.
- IMF (2010) *Regional Economic Outlook, Western Hemisphere: Heating up in the South, Cooler in the North*, October.
- IMF (2011), *World Economic Outlook*, April.
- Kaminsky, Graciela L., Carmen M. Reinhart and Carlos A. Végh (2004), “When It Rains, It Tours: Pro-cyclical Capital Flows and Macroeconomic Policies”, *NBER Working Paper No. 10780*, September, National Bureau for Economic Research, Cambridge, MA.

- Kindleberger, Charles P. and Robert Aliber (2005), *Manias, Panics, and Crashes: A History of Financial Crises* (5th edition), New York: John Wiley and Sons.
- Krugman, Paul and y Lance Taylor (1978). “Contractionary effects of devaluations”. *Journal of International Economics* 8: 445-56.
- Llaudes, Ricardo, Ferhan Salman and Mali Chivakul (2010), “The Impact of the Great Recession on Emerging Markets”, *IMF Working Paper WP/10/237*, October.
- Marfán, Manuel (2005), “La eficacia de la política fiscal y los déficit privados: un enfoque macroeconómico”, in José Antonio Ocampo (comp.), *Más allá de las reformas: Dinámica estructural y vulnerabilidad macroeconómica* (ed.), Bogotá: ECLAC, World Bank and Alfaomega.
- Martner, Ricardo and Varinia Tromben (2003), “Tax Reforms and Fiscal Stabilization in Latin America”, In *Tax Policy*, Public Finance Workshop Proceedings, Banca d’Italia Research Department, Rome, pp. 140-71.
- Minsky, Hyman P. (1982), *Can “it” Happen Again?: Essays on Instability and Finance*, Armonk, New York: M. E. Sharpe.
- Ocampo, José Antonio (2003), “Capital account and counter-cyclical prudential regulations in developing countries”, in Ricardo Ffrench-Davis y Stephany Griffith-Jones (eds.), *From Capital Surges to Drought: Seeking Stability for Emerging Markets*, London: Palgrave/Macmillan.
- _____ (2008), “A Broad View of Macroeconomic Stability”, in Narcis Serra and Joseph E. Stiglitz (eds.), *The Washington Consensus Reconsidered*, New York: Oxford University Press, 2008, Chapter 6.
- _____ (2009), “Latin America and the Global Financial Crisis”, *Cambridge Journal of Economics*, Vol. 33, No. 4, July.
- _____ (2011), ¿Cómo fue el desempeño de América Latina durante la crisis financiera global? *Ensayos Económicos*, Banco Central de la República Argentina, No. 61/62, January-June.
- _____ and Robert Vos (2008), *Uneven Economic Development*, Himayatnagar, London and Penang: Orient Longman, Zed Books and Third World Network, 2008.
- _____, Codrina Rada and Lance Taylor (2009), *Growth and Policy in Developing Countries: A Structuralist Approach*, New York: Columbia University Press.
- Ostry, Jonathan D., Atish R. Ghosh, Karl Habermeir, Marcos Chamon, Mahvash S. Qureshi, and Dennis D. S. Reinhardt. “Capital Inflows: The Role of Controls.” IMF Staff Position Note SPN/10/04, February 19, 2010. www.imf.org
- Reinhart, Carmen and Kenneth Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly*, Princeton: Princeton University Press, 2009.
- Rodrik, Dani and Andrés Velasco (2000), “Short-Term Capital Flows”, in *Proceedings of the Annual World Bank Conference on Development Economics 1999*, World Bank, Washington, D.C., pp. 59-90.

- Saurina, Jesús (2009), “Dynamic Provisioning, The Experience of Spain”, World Bank, Financial and Private Sector Development Vice-presidency, *Policy Note No. 7*, July.
- Stiglitz, Joseph E. (1998), “More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus”, UNU-WIDER, 2nd Annual Lecture, available at: http://www.wider.unu.edu/events/annual-lecture/Past-annual-lectures/en_GB/1998/
- ____ and Amar Bhattacharya (2000), “The Underpinnings of a Stable and Equitable Global Financial System: From Old Debates to a New Paradigm”, in *Proceedings of the Annual World Bank Conference on Development Economics 1999*. Washington, D.C.: World Bank, pp. 91-130.
- ____, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar (2006), *Stability with Growth: Macroeconomics, Liberalization, and Development*. New York: Oxford University Press for the Initiative for Policy Dialogue, Columbia University.
- Svensson, Lars E. O. (2000). “Open-economy Inflation Targeting”. *Journal of International Economics* 50: 155-83.