Chapter 15
Perspectives on Co-operative Policy Solutions: Argentina

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In the 1990s, Argentina made an effort to increase financial deepening, integrate with international markets and curb inflation. Key elements of its strategy were the improvement of prudential regulations, the deregulation of the capital account, the fostering of financial dollarization and the implementation of a currency board. Between 1991 and 1998, the country grew, the inflation rate converged to international standards and the economy passed the stress test posed by the 1995 Mexican peso shock. Based on these results, the Argentine strategy was praised and considered by many to be an example to follow. Some observers nonetheless argued that the framework was too rigid for emerging economies.

The events that followed the international financial turmoil of the late 1990s justified these concerns. The lack of flexibility to adapt to the changing international conditions resulted in a pro-cyclical deleveraging of the dollarized banking system, a sudden stop in capital inflows, the demise of the currency board in 2002 and, finally, the meltdown of the financial regulations that had been implemented. The credit crunch, together with the lack of access to sufficient compensatory finance from multilateral institutions, resulted in the most severe economic downturn in decades. Notwithstanding, after undergoing a period in which the unemployment rate rose above 20 percent, Argentina began to grow in 2003 and has been growing quickly since then. After the crisis — isolated from international markets and enjoying the benefits of improved terms of trade — the authorities adopted a strategy that privileged self-insurance. Thanks to central bank intervention, international reserves increased substantially and the country has run twin fiscal and current account surpluses for six consecutive years; a depreciated currency played a role in this strategy. The rebuilding of an institutional and policy framework that is friendly to financial intermediation and low inflation, however, has lagged behind. As a consequence, despite reinforced self-insurance, the economy remains vulnerable to financial and terms of trade shocks of a certain magnitude, which explains why macroeconomic conditions have recently worsened.

The Argentine case has particularly marked features. But Argentina's experiences with crises and recovery are far from unique. Indeed, they highlight a set of features that have been typically present — although with varying degrees of intensity — in financially troubled emerging countries. More specifically:

- Misleading macroeconomic policies and weak financial regulations and supervision, which resulted in excessive external exposure, have traditionally played a central role in nurturing financial disequilibria.
- Financial disarray has been extremely costly from the fiscal and political points of view. As a rule, the fiscal imbalances provoked by the bailout of the banking system eroded public debt sustainability. Furthermore, crisis-related fiscal expenditures crowded out social and public investment expenditures, affecting development and political legitimacy.

- Because of credit crunch, financial stress has always caused strong output losses. Key in this regard has been the inability to conduct appropriate fiscal and monetary anti-cyclical policies in a context in which capital flows behaved counter-cyclically, driven by sudden changes in risk aversion and domestic deleveraging. In addition, the resources that international financial institutions (IFIs) provided to counterbalance capital outflows and ease the credit crunch did not suffice to significantly smooth aggregate fluctuations. More often than not, the conditionality attached to the funds did not help either.
- The overall stability of world capital markets was never seriously jeopardized by the instability of emerging countries. Consequently, troubled economies perceived the global economy as an opportunity (rather than a menace) to supersede the downturns that accompanied national or regional crises. In particular, a number of countries that experienced episodes of financial stress and sudden stops adopted a mercantilist stance aimed at recovering growth by boosting exports and increasing central bank reserves.

In light of these stylized facts, the spread of the current financial turbulence to emerging and less developed countries is raising serious concerns. One additional source of uncertainty is that the crisis has novel characteristics: it is global and did not originate in a developing country. Under these new circumstances, previous diagnostics and strategies to face external shocks may have become updated. In particular, the pre-subprime crisis diagnostic exercises considered that financial instability was primarily a national problem, rooted in policy and institutional flaws and, consequently, the problems should be addressed domestically. To be sure, the diagnostic did not overlook the role of financial contagion and the deleterious effects on trade and the notion that a better international financial architecture could help. But, still, the bulk of policy action had to occur within national boundaries.

A good number of emerging countries gave serious consideration to this diagnostic and acted accordingly. First, they made substantial efforts to strengthen financial regulations and supervision; these efforts were paralleled at the international level by the creation of institutions and spaces for dialogue, such as the Financial Stability Forum (FSF) and the G20 finance forum. Second, macroeconomic policies were considerably streamlined. Steps were taken to increase the independence of the central bank and to implement fiscal responsibility laws aimed at reducing the risk of debt bias. Third, to face sudden capital stops and create room for anti-cyclical responses, emerging countries have been accumulating reserves and creating sovereign funds. In line with this self-insurance strategy, a set of countries have been running current account surpluses, contributing heavily to the world's supply of loanable funds. Incidentally, these actions suggest that the institutions of the international financial architecture were perceived to be unreliable with regard to crisis prevention and management. These efforts were rewarded. In the years that preceded the subprime crisis, risk premiums fell and some bonds were reclassified as investment grade.

The strategy based on sounder macroeconomic fundamentals and domestic institutions plus self-insurance seemed to work well and, in such a context, the efforts to improve the international financial architecture faded. Each country, following its best interests, contributed to producing the best international outcome with regard to global stability. But it was precisely when this idea was gaining momentum that "it" happened again in the developed world and the turbulence quickly hit the coasts of emerging

economies, revealing that international co-ordination and co-operation were necessary after all. It is no wonder, then, that there are strong demands to restructure the IFIs in order to address the global imbalances and regulatory problems in a co-ordinated way. The G20 summit in Washington is, of course, a valuable space for dialogue on the reform of the international financial architecture and for listening to what the emerging countries have to say.

Among the most relevant international co-ordination failures that could jeopardize financial stability in developing countries under the current circumstances, the following deserve consideration.

First, self-insurance can be self-defeating. The current crisis is associated with global imbalances that are probably not independent of self-insurance strategies. That is, the fear of sudden stops may have helped create a savings glut in some key emerging economies and to induce excessive consumption and bubbles in certain developed countries. In addition, an excessive supply of loanable funds may have endogenously induced a relaxation of monetary policy and of the supervision of credit markets.

Second, a simultaneous and sharp drop in output in the developing world driven by the spread of the current financial instability can heavily contribute to depressing the world economy. In the 1990s, a distressed country could rely on the world economy to foster its post-crisis economic recovery via exports. If emerging countries hit by the financial turmoil followed this strategy all together in the near future, it would worsen international trade conditions. The disincentive to mercantilist, beggar-thy-neighbour policies calls for international co-ordination.

Third, it should not be overlooked that the current global imbalances are associated not only with pitfalls in financial regulations and monetary policies, but also with pronounced and long-lasting changes on the real side of the global economy. The most salient are the sharp changes in productivity and international competitiveness (China, India), in relative prices (oil and natural resources) and the world's sources of savings and effective demand (United States). Monetary policies and the adjustments in exchange rates in the developed world were not efficient enough to facilitate the correction of global imbalances, in light of the results. Policy and regulatory decisions were mainly made at the center of the global economy, but they also affected the periphery. It seems only natural that emerging countries demand a greater involvement in the decision-making process. This, of course, calls for voice and representation in the institutions of the international financial architecture.

It must be taken into account, nonetheless, that emerging countries have a limited institution-building capacity and that it is very difficult to preserve good policies and rules under volatile conditions and political turmoil. Hence, the reform of the international financial architecture must be co-ordinated with regional and domestic financial architecture building. Regional agreements can help as an intermediate stage to co-ordinate national and multilateral initiatives. The Chiang Mai initiative and Latin America's reserves fund (FLAR) are good examples of institution building; furthermore, a regional arrangement may be a suitable mechanism for mobilizing financial resources from surplus countries.

In sum, under the current circumstances, it seems that emerging and less developed countries could greatly benefit if the reforms of the international financial architecture focused on the following.

- Mechanisms should be improved to prevent episodes of financial stress and sudden stops. This is central for emerging countries to avoid inefficient strategies of self-insurance. A malfunctioning international financial architecture creates incentives for the authorities to follow mercantilist strategies and manipulate exchange rates.
- Policy decisions oriented aimed at the existing global imbalances must consider the effects on the developing world. This is particularly relevant with respect to exchange rates and initiatives to restore liquidity conditions in the global markets. Developing countries must be able to participate in the groups and institutions that seek to co-ordinate international decisions in accordance with their importance concerning global sources of growth.
- The protection of world growth is vital to avoid a painful global depression. Just-in-time facilities should be made available to prevent credit crunch and facilitate counter-cyclical fiscal and monetary actions aimed at sidestepping serial downturns in the developing world. Since the problem is global, these facilities should not be circumscribed to strategic emerging economies, and the conditionality should both provide incentives to adopt sound policies and protect economic activity. In this sense, the recent steps taken by the International Monetary Fund and the United States Federal Reserve System to preserve the liquidity of financial markets in key emerging economies are only first steps in the right direction. The extended facilities should not be circumscribed to short-run liquidity problems and should not overlook non-strategic countries. To this purpose, institutional mechanisms should be designed to mobilize the resources of countries that are generating a structural surplus.
- The negative effects of the global turbulence on the institutional infrastructure that supports financial intermediation in developing countries must be minimized. Institutional reconstruction is far more difficult in emerging economies, and recommendations about standards and codes will not be enough. Developing countries need a blueprint as well as appropriate strategies for institution building and enforcement (see Fanelli 2008). The idiosyncratic features of emerging economies must be considered: the types of shocks that normally hit the economy, the degree of volatility, the quality of the overall institutional framework and political restrictions. The participation of emerging countries in institutions such as the FSF would greatly help to design appropriate blueprints and institution-building strategies. Finally, political legitimacy matters for institution building and, consequently, the goal of mobilizing resources for development must be part and parcel of the strategies to strengthen the banking sector and capital markets.

Reference

Fanelli, José María, ed. (2008). Macroeconomic Volatility, Institutions and Financial Architecture: The Developing World Perspective. (Basingtoke: Palgrave Macmillan).