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Hausmann, Ricardo, and Helmut Reisen (eds.), *Securing Stability and Growth in Latin America. Policy Issues and Prospects for Shock-prone Economies.* Paris 1996. OECD. 299 pp.

Latin America is back. The cold days in the aftermath of the debt crisis of 1982 – the so-called lost decade – seem to be forever gone. Latin American countries, only a few years ago living on the brink to hyperinflation and apparently unable to free themselves from welfare-decreasing policies, are suddenly facing strong demand by international investors seeking the thrills of high return/hig risk opportunities in the world's emerging markets. What happened? A number of Latin American countries took advantage of the crisis during the 1980s to implement policies emphasising sound money, openness, and small government, all of them policies that had not been very popular in the region during the 1960s and 1970s. Only a small group of countries, notably Chile and Colombia, had managed to switch earlier to growth-enhancing policies.

To many, Latin America's exceptional development in the early 1990s appeared like a tale of the unexpected. Restored democratic institutions and the rapid improvement of key macroeconomic indicators contributed to a mounting credibility of economic reforms domestically. Abroad, the fruit of reform did not impress much, for the prevailing scepticism was too strong. For too many years Latin America had come close to a real-world laboratory for the study of alternative approaches to stabilisation, trade and industrialisation; the region had become well known for its inconsistent economic programmes and its addiction to stop-and-go policies. Not surprisingly, the Mexican Peso crisis of December 1994 and its impact on the capital account of other Latin American countries (the so-called tequila effect) seemed to have rewarded the sceptics. The debate about the appropriate policy approach for the region was reopened again: Latin American economies had fared badly in the past with excessively inward-oriented policies and were now perceived to be suffering again, not from misguided economic advice, but rather from the consequences of market-oriented policies.

The volume edited by *Ricardo Hausmann*, Inter-American Development Bank, Washington, and *Helmut Reisen*, OECD Development Centre, Paris, plays a role in this debate. It sets out to remind us that, in spite of the far-reaching reforms implemented so far, Latin America largely consists of shock-prone economies subject to a high degree of macroeconomic volatility. The central message in the book is that the disequilibria recently experienced by Mexico could repeat themselves anytime (in Mexico or in any other Latin American country) under the reformed policy regime, unless the region's vulnerability to external and internal shocks is substantially reduced and volatility is taken as seriously as any other one of the many sins of economic policy deeply rooted in Latin America.

Eight policy-oriented papers presented at a conference held in November 1995 are included in the proceedings volume. They cover a wide array of topics, ranging from volatility, exchange rate policies and factor markets to institutional aspects of fiscal policy. In their paper, *Ricardo Hausmann* and *Michael Gavin* from the Inter-American Development Bank, Washington, put forward two main hypotheses, that (i) Latin America is volatile and that (ii) volatility is costly. In doing so, they address many of the issues discussed in the 1995 Report of the Inter-American Development Bank of Economic and Social Progress in Latin America, which was at least in part drafted by the same authors. By measuring volatility with the level of the standard deviation of real and monetary time series over the 1970–1992 period, the authors are able to show that volatility is generally higher in Latin American countries than in industrial and some Southeast Asian countries. Interestingly enough, with the sole exception of inflation, measured volatility is not identified as a typical feature of Latin America: it can be observed to be much higher on average in other developing regions such as Africa and

the Middle East. Concerning the economic cost of volatility, the paper reports results from a Barro-type growth regression indicating that average growth of per capita gross domestic product (GDP) was 1 percentage point lower in Latin America than in the industrial countries and that, due to the relatively low initial income of Latin American countries, the "conditional convergence term predicts that Latin America's growth should as a result have been nearly 2 percentage points higher than that of the industrial economies" (p. 29). The growth gap between actual and potential growth of Latin American countries (as compared with industrial countries) is thus estimated to have reached nearly three percentage points in the period under study. Volatility is said to have accounted for one percentage point or about a third of the growth gap, an underinvestment in human and physical capital for another 1 and 0.5 percentage points, repectively.

Instead of a final section with a summary of the key empirical results and some qualifications of the Barro approach, which has been the subject of fundamental methodological criticism in recent years,[1] the reader gets an extensive second part of the paper in which the authors attempt to identify the main sources of volatility and to draw policy conclusions. *Silvio Borner*, University of Basle, offers some striking comments on the second part of the paper. As concerns the causes of volatility he asks: "Can we really learn from the paper in this respect? Do the authors not explain volatility by volatility?" (p. 68). With reference to the policy recommendations he concludes that they "include hardly anything new or institutional: what we get is the old Washington Consensus in a new form (volatility)" (p. 68), thereby referring to the concept coinded in 1989 by John Williamson, Institute of International Economics, Washington.[2] Another commentator, *Zanny Minton Beddoes*, The Economist, London, ciriticises that "by trying to cover so much ground, the paper fails to develop many of the important linkages between causes and consequences of volatility" (p. 75). Hence it is fair to say that a paper restricted to the first two topics dealt with (estimates of the extent of volatility and of its economic cost) would have made much more sense.

Another interesting paper in the book deals with the optimal exchange rate regime for a volatile open economy living with a moderate rate of inflation, undoubtedly a topic that ranks high on the policy agenda of most Latin American countries today. The role of nominal anchors is analysed under the realistic assumption that many governments of the region are unwilling (or politically unable) to submit themselves to the harsch fiscal discipline imposed by fixed exchange rates and tight money aggregates. *Leonardo Leiderman* and *Gil Bufman*, two economists from Tel-Aviv University, thoroughly assess two policy instruments, crawling exchange rates and inflation targeting. After carefully scrutinising the recent experience of several countries with these instruments the authors conclude that they should be either considered alternatives or be ranked in terms of policy priority, in order to avoid the sort of conflicts that can arise between defending a currency band and maintaining or achieving an inflation target. For shock-prone economies that have already attained disinflation they recommend giving inflation targeting the highest priority. In his comment, *Chales Wyplosz*, INSEAD, Fontainebleau, observes that countries that were largely immune against the tequila effect (Chile and Colombia) had adopted measures aiming at extending the

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[1] See, among others, Quah, D. (1993). Galton's Fallacy and Tests of the Convergence Hypothesis. Disussion Paper EM 265. London School of Economics, London.

[2] See the report on a 1989 conference by Williamson, John, *The Progress of Policy Reform in Latin America*, Policy Analysis in International Economics, Institute for International Economics, Washington, January 1990, pp. 9–33, and, by the same author, "What Washington Means by Policy Reform". In John Williamson (ed.), *Latin American Adjustment: How Much Has Happened?* Washington 1990, pp. 5–20.

minimum period during which foreign portfolio investment cannot be repatriated. While touching upon the close links between the exchange rate regime and domestic financial markets Wyplosz hypothesises that restrictions on short-term capital inflows might have a beneficial impact on the performance of both crawling exchange rate bands and inflation targets. His advice is that temporary restrictions on portfolio investment should be complementary to the instruments discussed by Leiderman and Bufman and that such restrictions should be kept in place until the reputation eventually accrueing to the monetary authorities allows them to move to a truly flexible exchange rate.

Latin American financial markets are the subject of another important paper included in the volume which was prepared by *Liliana Rojas-Suarez* and *Steven R. Weisbrod*, economists with the Inter-American Development Bank. They attribute macroeconomic instability to the short-term nature of financial assets and liabilities existing in Latin America. This, so they state, tends of facilitate the withdrawal of funds at short notice in response to expectations of an imminent crisis. Thus the problem of reducing macroeconomic instability is recasted by the authors in terms of strengthening financial markets by either (i) increasing international liquidity or (ii) creating new investment opportunities in form of long-term securities. The attainment of both objectives is expected to make short-term assets (and the high probability of their instant withdrawal) virtually irrelevant for macroeconomic development. The usual procedure for increasing international liquidity is to place high reserve requirements on bank deposits and to invest reserve funds in liquid international assets. This works best in countries in which bank deposits constitute the major short-term asset, as it is the case in most of Latin America. However, reserve requirements are no panacea. They act like a tax on successful banks that attract high volumes of deposits, as is acknowledged by the authors, and they also have many other defects which show up prominently in economies with moderate to high inflation rates.

In lieu of reserve requirements the authors propose to introduce an appropriate supervision of banks and to substantially improve the accounting system and the legal framework for banking operations in Latin America, as a means of increasing the confidence of potential foreign and domestic investors. In spite of the fact that one of the commentators, *Hans J. Blommestein*, OECD, urges the authors not to overestimate the actual power of supervision and better rules, it should be noted that institutions and legal systems are notably weak in the region and that this weakness probably has been and still is a major source of economic and political instability in Latin America, as the economic analysis of law and public choice theory predict. For weak institutions and legal systems had set the stage for discretion and favouritism in the banking business during the decades of financial repression in the region. Moreover, in discussing the relationship between banking structure and capital markets the authors as well as the commentator anticipate that the further development of financial markets will sooner or later necessarily impose on Latin American governments a decision concerning the choice between the German and the Anglo-Saxon banking systems. Their warnings against the risks commonly associated with the German system of "Universalbanken", though, seem to be totally out of tune with present-day Latin America financial markets: stock exchanges might be a useful tool to raise capital for the few big enterprises that can be found in the more advanced countries of the region. For the great majority of firms, however, equity and other securities are still many decades away. The financial options these firms have basically boil down to just two: to satisfy their capital needs from retained earnings or to find a reliable (domestic or foreign) banker. Thus, the identification is that the current situation demands a strong role for banks in Latin American corporate finance. Besides one should note that deeper capital markets would be the preferable alternative, particularly in view of the wave of privatizations that is

sweeping through many Latin American countries. But the problem today does not seem to be one of ranking. It rather appears to be one of sequencing: institutions supporting the use of securities as the main source of finance for a large group of firms cannot be built overnight, neither in Latin America nor anywhere else; the deepening of capital markets requires a long-term effort. By contrast, the completion of the "Universalbanken" system could be achieved in one or two years.

One area of economic reform in which Latin American countries can be considered pioneers is social security. For example, one component of social security, the public pension system, has been substituted for a privately funded system in Chile already 16 years ago, and similar reforms are currently underway in countries such as Argentina, Colombia, Mexico and Peru, whereas in advanced countries such as Germany and Sweden, where the major deficiencies of the pay-as-you-go system have been clearly showing for years, policymakers are still far away from actively engaging in fundamental reform initiatives. The paper by *René Cortázar*, CIEPLAN, Santiago de Chile, gives an informed account of labour market policies in Latin America and especially in Chile, and proposes a market-oriented reform of the current system of unemployment insurance and assistance. High severance payments combined with low unemployment benefits accrueing only to those employed in the formal sector are hypothesized to have brought about a deep segmentation of labour markets in many Latin American countries. While the formal sector, which exists in the region's few relatively advanced countries, offers a certain degree of job security to its employees, the great majority of the workers, many of which spend their active lives in the informal sector, never saw either a proper labour contract or reliable unemployment insurance or assistance schemes. His proposal includes the creation of a private savings and loan fund to which employees and employers contribute on a compulsory basis. Every employee holds an account with the fund in which the contributions are accumulated and earn a minimum return; a fraction of contributions is allocated to the loan fund. In case of unemployment, the employee draws on his savings, and in case his savings should be exhausted before finding a new job, he can apply for a loan from the fund, assuming that the fund attains an adequate degree of coverage. The author claims that his proposal of a private fund avoids moral hazard and other consequences of traditional unemployment benefits. *Rolf Schinke*, University of Göttingen, finds some flaws in the private fund solution and recommends that the fund should resort to the government for help and finance. *Hugo A. Hopenhayn*, Rochester University, who models some aspects of Cortázar's savings and loan fund, points out that other sources of risk related to unemployment deserve equal attention in Latin America, like, for example, the loss of firm-specific human capital. To this one may add the risk of obsolescence of general human capital as well as the causes and implications of underinvestment in both specific and general human capital.

Besides an introductory paper on economic policy in Latin America by *Nancy Birdsdall* and *Carlos Lozada*, Inter-American Development Bank, and a conference summary by *Helmut Reisen*, the volume includes two further papers, one of them dealing with capital flows and the other one with institutional aspects of fiscal policy. The former, which was also written by *Helmut Reisen*, addresses some key aspects of international capital flows to the region and compares Latin America and Asia with respect to (i) the level, structure and destination of capital inflows and (ii) domestic policies with an impact on the capital account. Furthermore, the paper reviews many pros and cons of capital flows to developing countries found in the literature, with the exception of the arguments put forward by Robert E. Lucas[3] to explain why actual

[3] Lucas, R. E. (1990). Why Doesn't Capital Flow from Rich to Poor Countries? *American Economic Review, Papers and Proceedings* 80(2): 93–96.

capital flows from rich to poor countries do not conform to the prediction of the neoclassical paradigm of diverging marginal products of capital. The paper nevertheless constitutes a useful contribution to the study of capital flows to Latin America.

The chapter on the design of new institutional arrangements for fiscal policy is co-authored by *Ricardo Hausmann* and *Ernesto Stein*, the latter also from the Inter-American Development Bank. Given that the lack of fiscal discipline has been the central character in most of the Latin American economic drama of the last 50 years, this paper could easily be classified as the highlight of a collection of essays on the region. The issues touched upon are not only equally relevant for theory and policy. They are also of great importance for many other regions of the world, including the European Union. The authors first inspect three tools: constraints on the deficit, specific procedural rules, and the transparency of the budgetary process. Later on they extend their analysis to the role of Congress, the treatment of fiscal shocks, and fiscal sustainability. Although the spirit of the paper is that of an exploratory enquiry, as is recognised by both commentators, *Sweder van Wijnbergen*, University of Amsterdam, and *Jürgen von Hagen*, University of Mannheim, the implicit diagnosis is extremely clear: reform is desirable but politically difficult. The therapy recommended by the commentators (to which this reviewer fully adheres) is: continue the excellent work on this fertile and promising avenue of research.

In sum, the volume can be recommended to those interested in a policy-oriented and well-informed analysis of current developments in a region undergoing economic transformation at a breathtaking pace.

Federico Foders

Monticelli, Carlo, and Luca Papi, *European Integration, Monetary Co-ordination and the Demand for Money*. Oxford 1996. Clarendon Press, 223 pp.

With crucial dates laid down in the Maastricht treaty approaching fast, the number of articles and books written on European integration is steadily increasing. Several challenges remain unresolved. Apart from political decisions, such as the selection of participating countries and conversion rates, an important question is how ex ante co-ordination of national monetary policies can be improved and which policy strategy the European Central Bank should follow in order to ensure price stability. The theoretical and empirical analysis of Carlo Monticelli and Luca Papi support the case for focusing on the control of area-wide money supply. This central finding is embedded in a more general analysis of monetary co-ordination in Europe. Those working in this area may therefore find this book a useful reference.

Chapter I starts off with a review of the reasons for international policy co-ordination and discusses the experience of the European Monetary System in this respect, including the prospects of monetary union. The analysis highlights the importance of the appropirate degree of symmetry of an exchange rate system in order to cope with situations where national economic conditions require differentiated monetary policies.

Chapter II studies, within a simple stochastic two-country rational expectations model, the pros and cons of asymmetric and symmetric adjustment obligations when monetary authorities aim at stabilizing the price level. In the asymmetric regime, the anchor country keeps control over its money supply, while the second country gives up its monetary autonomy in order to ensure exchange rate stability. In case of symmetric adjustment obligations, co-ordination is pursued by an area-wide monetary instrument. The novel feature of the model is that the anchor country takes into account the implications of its policy on inflation developments in the neighbor country, i.e. the domestic objective function also includes the foreign inflation performance. The inclu-