Emerging Economies and the Business Cycle

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I will try to address the topic of this conference from the point of view of emerging economies. I believe that Mexico is a good example, and I would guess that I have a comparative advantage from that perspective, do I not?

Business Cycles in Emerging Economies

When analyzing time series of the GDPs of emerging economies, first we find that there appears to be a relatively close synchronization with industrialized countries' cycles. An old saying in Mexico, attributed to our last dictator of the nineteenth century, is that when the United States gets a cold, Mexico gets pneumonia. I think the saying is still valid, and it describes this aspect of the synchronization between emerging market economies and industrialized countries.

A second finding is that the time series of GDP for emerging economies exhibit greater volatility, as measured by the standard deviations of such series. In addition, there is a crucial difference between the depths of recessions in emerging economies and in industrial ones. While in the 1970-95 period the typical recession in industrialized countries registered a reduction in GDP of approximately 2 percent, in Latin America the average fall in GDP during a recession amounted to 8 percent. So at least in Latin America, instead of the typical expansion/recession cycle common in industrialized countries, the business cycle has more extreme values of crisis and recovery. Therefore, macroeconomic policies in emerging markets are focused on avoiding a possible

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crisis or attempting to reestablish credibility after one, instead of trying to fine-tune or smooth out the business cycle.

We also find an excess of volatility in GDP in emerging economies. A salient feature of emerging markets is that, on average, they are relatively more prone to be affected by large variations in their terms of trade. Therefore, shocks in terms of trade are likely to be a major source of economic fluctuations. In many emerging countries, export bases are characterized by a high concentration in a relatively small number of commodities whose world prices are very volatile. Also, their fiscal revenues tend to be largely dependent on the prices of the main export commodities, and so the health of their public finances as well is vulnerable to major changes in the world prices of export goods.

The Role of Capital Flows

Over the past decade, tighter integration of international financial markets and positive expectations of future growth and profitability in emerging market countries have triggered a sharp increase in capital flows to those economies. In particular, in the 1978-81 and 1990-94 periods, countries in a variety of cyclical situations and with different macroeconomic policies experienced a simultaneous surge in new capital inflows. The problem has been that those capital inflows have not always been stable and permanent. Particular conditions in the recipient countries have triggered the massive capital outflows common to recent experience in Asia and in Mexico. But factors external to the emerging markets, such as higher interest rates in industrialized countries, can also contribute to capital outflows.

The massive capital inflows have entailed major risks for those recipient countries with a predetermined exchange-rate system. The macroeconomic developments that result from a significant inflow of foreign capital, namely, real currency appreciation and increasing current account deficits, may eventually be conducive to a run on the domestic currency of the recipient country. And if the domestic financial system is weak, the interest rate increases required to support exchange rates in episodes of capital outflow can hardly take place, because they would generate a crisis in the financial system. In this sense, a weak financial system imposes major constraints on what monetary policy can do to defend a predetermined exchange rate system under stress.

Other Important Influences

Collapses of exchange-rate regimes and of local financial systems have unveiled deep recessions in several emerging market economies. Capital outflows have been involved in all of these episodes, but it is hard to claim that they were the sole factor responsible for the downturns in economic activity. In most cases, policy mismanagement or external developments have been contributing factors. Foreign capital has played the role of catalyst in emerging market crises, speeding up the collapses of regimes and substantially reducing the degree of freedom of action that the local authorities once had. When crises take place, the authorities suffer a complete loss of credibility. Macroeconomic policies, instead of fulfilling their output-supporting role, have to be adjusted so that the credibility of the authorities is restored. This is why, in contrast to industrial countries' experience, fiscal and monetary policies are usually pro-cyclical in developing countries.

It could also be argued that some of the volatility that we see in emerging market economies has been policy-induced. Some decisions on fiscal, monetary, and exchange-rate policies have in themselves represented significant destabilizing policy shocks to these economies. Some of the policy mistakes can be attributed to the fact that many emerging market economies still lack the appropriate institutional arrangements. In addition, policy mistakes can arise when authorities implement a policy mix forced onto a specific short-term objective, disregarding its sustainability in the medium and the long term. A typical example is the adoption of a strict exchange-rate stabilization program. This type of program tends to deliver a sharp decrease in inflation, but oftentimes at the cost of unsustainable real exchange-rate appreciation and external sector deficits. In this situation, the exchange-rate regime tends to collapse and the previous gains in the abatement of inflation are not sustained. A typical side effect is that such devaluations are contractionary.

In addition, the adoption of a predetermined exchange-rate regime encourages external borrowing by providing an implicit exchange-rate guarantee, and it leads to excessive exposure to foreign exchange risk in both the financial and the corporate sectors. Lax banking regulation and inadequate financial supervision lead to a sharp deterioration in the quality of banks' loan portfolios. This set of mistakes has proved to be at the source of recent balance-of-payments and banking crises around the world. In summary, terms of trade shocks, capital flows instability, and policy mistakes can be considered the salient factors that induce more GDP volatility in emerging economies than in industrialized ones. The identification of these factors is useful, since it provides us with the elements for the creation of a strategy that could prevent, or at least mitigate, recessions in emerging economies.

A Strategy to Reduce Volatility

The question then is, what are the policy options to reduce volatility in emerging market economies? First, emerging countries should seek to reduce the vulnerability of their economies to significant changes in the international prices of their export commodities. One policy option in this regard is to diversify export bases and productive systems by adopting more open trade and investment regimes. In many emerging countries, much can be done in terms of eliminating trade barriers that introduce the anti-export bias usually associated with protectionist measures. Emerging countries should also explore the possibility of developing strategies based on a more intense use of hedging instruments against commodity price fluctuations. Similarly, the creation of commodity stabilization funds can contribute to smoothing the revenue effect of those price fluctuations. With regard to the sensitivity of current revenues to commodity price fluctuations, as in all exporting countries, local authorities should engage in aggressive programs to fortify other sources of revenues. This might require basic tax reform and a campaign to combat tax evasion.

Most emerging market economies should also consider the role that market-determined interest rates and increased exchange-rate flexibility can play as shock absorbers. In Mexico's experience, the adoption of a flexible exchange-rate regime has substantially contributed to reducing speculative pressures in financial markets. This flexible exchange rate has served several purposes. First, it has provided us with an additional adjustment variable with which to absorb temporary shocks, such as the recent turmoil in financial markets triggered by the Asian crisis. Second, a flexible exchange rate facilitates adjustment of the real exchange rate toward its equilibrium level whenever an exogenous shock warrants a new level for the exchange rate, without affecting the credibility of the monetary authority. And third, the floating exchange-rate regime and the free determination of interest rates have discouraged short-term capital flows, because of the large losses that can be incurred by investors in the short run. Since the adoption of this regime, the nature of capital flows to Mexico has shifted from mainly short-term to long-term in nature. To give you an idea, before the crisis of 1990 to 1994, foreigners had over $34 billion in short-term investments in Mexico. As of today, they have less than $2 billion. That reduction can be attributed to the floating exchange-rate regime.

Although shock-prone economies can benefit from deep financial markets and flexible exchange rates, it is of paramount importance that policymakers ensure that financial institutions are sufficiently robust to withstand successfully major changes in the macroeconomic environment. More flexibility in financial markets cannot substitute for actions to strengthen the financial system through better prudential regulation and supervision. Emerging countries can also obtain benefits from reforming their institutions in such a way that their vulnerability to economic shocks and their propensity to commit policy mistakes would be reduced. In addition to improving the regulation and supervision of the financial system, action can be taken to achieve better coordination between fiscal and monetary policies. When there is a lack of coordination among the different aspects of economic policy, the monetary authority's actions may generate unnecessary disturbances to economic activity.

When talking about the role of policy mistakes as a source of economic instability, a particular case in point is one where the objectives of an institution are not correctly specified. In this sense, some positive institutional reforms can be introduced to diminish the vulnerability of the economy. Granting autonomy to the central bank and assigning to it the sole object of sustainable price stability is a step in the right direction. This institutional change may also reduce some of the time-inconsistency problems in policymaking that I mentioned before. Particularly relevant for the emerging countries is the need to seek greater flexibility in the labor markets. Overregulated labor markets create negative incentives for the adoption of new technologies and improvements in the quality of human capital. In addition, overregulated labor markets prevent the kind of wage flexibility that is so desperately needed to deal with external shocks.

Over the past decade, the emerging countries have made significant progress regarding structural change, through adjustments to the legal and regulatory frameworks of the economy as well as by continuing the process of divestiture of government-controlled enterprises. Further efforts in this regard can also be of much help in reducing the negative effect of economic shocks on real economic activity. Finally, emerging market economies should devise mechanisms and develop institutions with the purpose of reducing their dependency on foreign savings. Clear examples in this regard are reforms to social security schemes and pension funds.