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Editor's Summary

This second issue of *Economía* contains papers presented at the Panel Meeting held on 13 October 2000 in Rio de Janeiro. The topics covered are diverse, yet they all address the causes and consequences of the economic instability that has long affected Latin America.

In the past decade the region has made much macroeconomic progress, achieving what now seems like sustained low inflation. As the nasty effects of the Asian and Russian crises showed, however, Latin America remains extremely vulnerable to the vagaries of the world economy. Homemade problems also subsist: witness the recent fiscal and debt troubles in countries as different as Ecuador and Argentina. Additionally, the debate over the right exchange rate and monetary arrangements for the countries in the region remains as lively as ever. All these are subjects addressed in this issue.

Start with the problem of shocks from abroad. Kristin Forbes and Roberto Rigobon accept the premise that when the world sneezes, Latin America catches cold. Defining and measuring contagion, however, is not an easy task. If country A goes into recession and cuts imports from country B, causing this nation to suffer a recession as well, is this contagion or simply the workings of economic interdependence? To avoid this ambiguity, many economists define contagion as the propagation of shocks in excess of what can be explained by fundamentals. Yet this definition is also problematic. What are fundamentals? If the collapse in Russia suggests to investors in Brazil that the International Monetary Fund (IMF) may not be disposed to bail out the country in the event of a currency collapse, and these investors react by starting a run on the Brazilian real, is this a fundamental shock or contagion? Forbes and Rigobon propose a narrower definition of contagion that encompasses only measured shifts in how shocks are propagated between normal and crisis periods. On examining recent financial crises, they find little evidence of such shift-contagion in Latin America.

The finding has important—and controversial—policy implications. According to Forbes and Rigobon, linkages can strongly transmit shocks across economies, but the mechanisms of transmission are similar across time. This leads the authors to emphasize the role of conventional trade and relative price channels of transmission and to de-emphasize the importance of financial panics or other factors related to multiple equilibria that presumably only kick in at times of crisis. Their conclusion is that capital controls, international lenders of last resort, and other policies designed to prevent self-fulfilling crises are likely to have a minor effect at best. By contrast, sound fiscal and monetary management remains as important as ever.

Lending booms have been a common source of macroeconomic fluctuation in Latin America—and allegedly not a harmless one: a large academic literature blames such booms for subsequent output collapses and banking and currency crises. Pierre-Olivier Gourinchas, Rodrigo Valdés, and Oscar Landerretche analyze a broad sample of lending booms across the world, with a special emphasis on Latin America. They attempt to answer three questions. First, what do lending booms typically look like? Second, do they always end badly? Third, what commonly discussed causes of lending booms seem most plausible?

They find that the average lending boom is associated with a surge in domestic investment and consumption, a worsening current account deficit, real appreciation of the exchange rate, an increase in domestic interest rates, and a decline in output growth. Across the world, lending booms do not typically lead to increased vulnerability of the banking sector and the balance of payments, and hence they need not end badly. Latin America turns out to be atypical in this respect, however: lending booms in the region are often followed by financial and currency crises. This observation, together with the fact that home interest rates are particularly high and capital inflows especially large in the Latin American episodes, leads the authors to conjecture that the most likely cause of lending booms in the region is the combined effect of financial liberalization and poor regulation and supervision. Other commonly advanced theories, which explain the surge in borrowing as a natural and healthy consequence of positive productivity shocks or of anticipated increases in wealth, are not congruent with the stylized empirical facts reported in the paper. Gourinchas, Valdés, and Landerretche conclude: "Speed limits (to constrain borrowing) could well have some rationale in Latin America."

Among policies intended to alleviate macroeconomic instability, one is quickly gaining popularity in the region: the abandonment of the national currency and the adoption of the U.S. dollar. Ecuador and El Salvador have recently chosen this path, while Argentina, Costa Rica, and Nicaragua have reportedly considered it. But what do we know about the long-term consequences of dollarization? Is the policy the panacea that its advocates often claim it is? Ilan Goldfajn and Gino Olivares tackle these questions by studying the region's only example of a long experience with dollarization in a small-but-not-minuscule economy: Panama.

They find that in one dimension the policy has been extremely successful: inflation in Panama has been low, even in periods during which much of the rest of Latin America was experiencing hyperinflation or something close to it. Dollarization seems to help in two additional areas: domestic interest rates are consistently lower than in the rest of Latin America, and they seem to be relatively insensitive to world confidence shocks (measured as drops in an index of emerging market bond prices).

Dollarization turns out to be no panacea, however. Panama's growth rate over the sample period is below that of the average developing country, though not much different from the Latin American average. Some measures of output volatility are higher for Panama than for almost every other country in the region. Contrary to a currently popular view, dollarization does not do away with a substantial and highly volatile country risk premium. Furthermore, the fiscal discipline that a noninflationary monetary regime could conceivably engender is nowhere in sight in Panama.

Fiscal policy is also the subject of the paper by Mariano Tommasi, Sebastián Saiegh, and Pablo Sanguinetti. Central government deficits have fallen almost everywhere in the region, but the performance of subnational governments remains problematic in several countries. Argentina, Brazil, and Colombia, where budget policy is most decentralized and fiscal federalism strongest, stand out in this regard.

The paper begins by documenting the problems with Argentine fiscal federalism. The authors argue that the system is very inefficient, with high spending, poor tax collection, large deficits, increasing indebtedness among provincial governments, and occasional federal bailouts to alleviate provincial imbalances. Conventional economic theory predicts some of these problems for fiscally decentralized regimes because of the incentive distortions that arise when the benefits of spending are local but the sources of financing are largely national: this is the so-called commons problem. That type of theory, however, fails to explain why these political arrangements arise if they are so obviously inefficient.

Tommasi, Saiegh, and Sanguinetti sketch out a model that characterizes such fiscal institutions and outcomes as the product of national political transactions among the provinces, carried out in an environment of no commitment and exogenous political and economic shocks. In the model, first-best allocations typically cannot be attained, and outcomes often display several inefficiencies: the inability to sustain cooperative arrangements, too much unjustified policy volatility, and too little responsiveness to fundamental economic shocks. The authors then map the predictions of the model to Argentina; they argue that the framework helps explain some of the inefficiencies of the current system.

What can be done about it? The paper maintains that trying to change federal fiscal rules alone will not do, because reform will be blocked as long as the underlying political game remains unchanged. Alternatively, budget policy changes will simply cause the inefficiencies to express themselves through other channels. The paper instead calls for fundamental constitutional reform, intended to curtail the dependency of national legislators on local party elites and limit the discretion of the national executive power in the budgetary process. It also calls for the creation of a federal fiscal institution, which could provide an arena for managing fiscal relations between the national and provincial governments, thereby reducing the current reliance on special deals and agreements that often prove unenforceable.

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