



Financial instability in Latin America[☆]

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Abstract

In this paper I deal with a number of issues related to financial instability in Latin America. I first discuss, from a macroeconomic research perspective, what I believe are some of the most important policy issues faced by the Latin American nations. These include the effectiveness of controls on capital inflows, the effect of exchange rate depreciation on output, and the international transmission of the business cycle. Second, I argue that the economic research agenda on Latin America should not ignore history. In Latin America, more so than in any other region in the world, there has been a self-destructing tendency for repeating history.

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JEL classification: F30; F32

Keywords: Financial instability; Capital controls; Devaluation; Latin America

1. Introduction

During the 1990s the vast majority of the Latin American countries embarked on ambitious reform programs aimed at opening up their economies, reducing inflation, privatizing state-owned enterprises and deregulating the business sector. These reform packages came to be known as the “Washington Consensus”, and were originally praised for their boldness and reach. Many analysts, including senior officials from the multilateral institutions, argued that these reforms marked a turning point in the history of the region. The adoption of market orientation,

[☆] This is a revised version of presentation made at the University of California, Santa Cruz Conference “Regional and International Implications of Financial Instability in Latin America”. I thank Joshua Aizenman and Jim Lothian for comments, support and encouragement.

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the argument went, would result in growth, stability, a reduction in poverty and, eventually, in prosperity. Almost fifteen years after the reforms were launched the verdict is much more sober. For one thing, prosperity in Latin America is today as elusive as at any time in the past. Moreover, since the mid-1990s the region has been affected by crisis after crisis—Mexico 1994, Ecuador 1998, Brazil 1999, Argentina 2001, Venezuela 2002, Uruguay 2002—and financial instability appears to have become the norm, rather than the exception.

Since the late 1990s academics have become increasingly interested in understanding the sources of financial instability in Latin America during the post-reform era. Models have been developed and empirical papers have been produced. Much of this work has been technical, and has emphasized issues such as multiple equilibria, self-fulfilling crises, sunspots and other developments in modern macroeconomics.¹ A smaller number of scholars have turned to political economy models in an effort to understand what has happened in the region during the last few years. In particular, some authors have looked at the role of fiscal federalism as an explanation for the region's perennial fiscal imbalances. Others have become concerned about the possibility of a return of populist policies, such as the ones that were common in the region until the late 1980s.²

At the time of this writing, the general mood with respect to Latin America—a mood that has not been captured by the more technically oriented academic researchers—is one of deep pessimism. In multiple meetings during 2002–2003 politicians, analysts, and pundits of various types have talked of the “lost half decade.” Many have argued that implementing the reforms of the “Washington Consensus” was a mistake, and many have embraced the criticism of the multinationals as their new banner—see [Stiglitz \(2002\)](#). This pessimism about the *long-term* prospects for Latin America is also apparent among private sector analysts. Paradoxically, perhaps, this is the case in spite of the remarkable rally in the market for Latin American sovereign debt experienced during the first half of 2003.³

In this paper I deal with two broad topics related to financial instability in Latin America. In Section 2 I discuss what I believe are some of the most important policy issues faced by the Latin American nations. I deal with these issues from a macroeconomic research perspective, and I emphasize those areas where I believe the economics profession needs to focus its analytical and empirical efforts. While in some cases I sketch what I believe are the more promising avenues of inquiry, in others I provide preliminary results. In Section 3 I focus on some *lessons from history*, and I argue that in moving forward in its research agenda on Latin

¹ The papers in this issue of the *Journal of International Money and Finance*, and those cited by them, are a good example of this type of work.

² On populism in Latin America see [Dornbusch and Edwards \(1990\)](#). On criticisms on the reforms see, for example, [Stiglitz \(2002\)](#).

³ A good example of this private sector pessimism is the op-ed by former Solomon Brothers Chief Emerging Markets Strategist, Desmon Lachman, “The False Optimism of the Emerging Markets”, *Financial Times*, May 20th, 2003, p. 15. In this article, the author argues that the rally in Latin American sovereign debt is not justified on the bases of the region's fundamentals.

America, the economics profession should not ignore history. After all, this is a region with an incredibly rich historical past, and ignoring it may not only lead analyst in the wrong direction, it may also be costly from a policy point of view. In Latin America, more so than in any other region in the world, there has been a self-destructing tendency for repeating historical errors. Finally, in Section 4 I present some concluding remarks.

2. Financial instability and macroeconomic policy in Latin America

Recent research on financial instability in Latin America, including the papers collected in this issue of the *Journal of International Money and Finance*, has made important progress in trying to understand the causes behind macroeconomic volatility in the region. Particular attention has been given to the following issues: (1) The way in which traditional arguments on the selection of the exchange rate regime are affected by the existence of “balance sheet” effects. (2) “Fear of floating”, or the alleged reluctance by the region’s authorities to let the exchange rate float freely. (3) The effects of IMF programs, including its moral hazard consequences. (4) The effects of the liberalization reforms of the 1990s on economic instability and growth. (5) The costs and benefits associated with “hard peg” exchange rate arrangements, including dollarization and currency boards. And, (6) optimal exit strategies out of fixed exchange rate regimes.

These are, indeed, important topics, which look at the region’s instability problem from many different perspectives. In my opinion, however, there are a number of additional topics that deserve attention, if we want to understand fully the forces behind instability, the consequences excessive volatility in the short and long term, and if we want to provide guidance to policy makers in the region. In what follows I will sketch a minimal and partial research agenda for the future. My purpose is not to be exhaustive; rather, I will try to develop a selected list of topics that in my view should receive greater emphasis by researchers and scholars.

2.1. Capital controls

Many of the critics of the “Washington Consensus” and of the reform process have argued that unrestricted capital mobility has been at the center of financial instability during the last few years. According to this view, an open capital account encourages speculative capital inflows during good times; when conditions change, and the domestic economic climate deteriorates, these speculative funds leave the country rapidly, leaving behind havoc and destruction. According to this view, in order to reduce the extent of financial instability, emerging markets should control *capital inflows*. Most authors that have supported this view have argued that these controls should be similar to those enacted by Chile during the 1990s. Interestingly, in May 2003 the governments of both Argentina and Brazil—two countries seriously affected by crises and instability in the immediate past—stated that they were contemplating adopting Chilean style controls as part of its longer run recovery programs. According to the authorities, the use of these types of controls

would allow them to maintain a “competitive” real exchange rate at the same time as they implemented a tight monetary policy.

Chile introduced restrictions on capital inflows in June 1991.⁴ Initially, all portfolio inflows were subject to a 20% reserve deposit, which had to be kept in Chile’s Central Bank and that earned no interest. For maturities of less than a year, the deposit applied for the duration of the inflow, while for longer maturities, the reserve requirement was for one year. In July 1992 the rate of the reserve requirement was raised to 30%, and its holding period was set at one year, independent of the length of stay of the flow. Also, at that time its coverage was extended to trade credit and to loans related to foreign direct investment. New changes were introduced in 1995, when the reserve requirement coverage was extended to Chilean stocks traded in the New York Stock Exchange (ADRs), to “financial” foreign direct investment (FDI), and bond issues. In June of 1998, and as a way of fighting off contagion coming from the East Asian crisis, the rate of the reserve requirement was lowered to 10%, and in September of that year the deposit rate was reduced to zero. Throughout this period Chile also regulated foreign direct investment: until 1992, FDI was subject to a three year minimum stay in the country; at that time, the minimum stay was reduced to one year, and in early 2000 it was eliminated. There are no restrictions on the repatriation of profits from FDI.

This system of deposits that earn no interest is equivalent to a tax on capital inflows. The rate of the tax depends both on the period of time during which the funds stay in the country, as well as on the opportunity cost of these funds. As shown by Valdés-Prieto and Soto (1998) and De Gregorio et al. (2000), the tax equivalent for funds that stay in Chile for k months, is given by the following expression:

$$\tau(k) = [r^* \lambda / (1 - \lambda)] (\rho / k), \quad (1)$$

where r^* is an international interest rate that captures the opportunity cost of the reserve requirement, λ is the proportion of the funds that has to be deposited at the Central Bank, and ρ is the period of time (measured in months) that the deposit has to be kept in the Central Bank.

Whether controls based on this principle indeed work, and are beneficial to the country in question is still subject to debate. Indeed, while authors such as Krugman (1999) and Stiglitz (2002) claim that they reduce instability, much of the empirical work on the subject is mixed. While there is evidence that the average maturity of Chile’s external debt increased after the controls, there is not much evidence that they helped reduce instability, or they helped the country avoid “contagion” stemming from the currency crises of the 1990s. As capital flows to the emerging countries resume in the future—as they unavoidably will—the question of the effectiveness of this mechanism—including its costs—will become particularly important.

⁴ Chile had had a similar system during the 1970s. See Edwards and Cox Edwards (1991).

A related issue, and one that requires significant additional attention by economists, is when to remove impediments to capital mobility. A first step in answering this question is determining the long-term consequences of capital mobility on economic performance. As Stiglitz (2002) has argued, this is a difficult question, and one about which we have limited evidence. However, recent research that uses new and improved measures on the degree of openness of capital mobility, suggests that a freer capital account has a positive effect on long run growth in countries that have surpassed a certain stage in the development process. According to preliminary findings, this threshold effect appears to be related to the strength of domestic institutions and of domestic capital markets. The issue of *how* to move towards greater capital mobility is highly complex, and is clearly among those that require additional research.⁵

2.2. Contractionary devaluations

The question of whether devaluations are contractionary and result in a decline in GDP, has for years been a recurrent theme in the emerging markets' economics literature. This possibility, which contradicts the implications of macroeconomic models of the Mundell-Fleming tradition, was suggested early on by Hirshman (1949), and was further elaborated by Diaz Alejandro (1965) in his celebrated study on exchange rate policies in Argentina. Both of these authors, as well as a number of scholars after them, concluded that whether a devaluation was indeed contractionary was an empirical and country specific issue—see Krugman and Taylor (1978).

During the 1980s, and partially as a result of the debt crisis of 1982, a number of authors focused, once again, on the effects of devaluations on real economic activity—see, for example, Branson (1983). Although these analyses were inconclusive on the importance of the effect, the idea that devaluations could have a negative impact on economic performance influenced a number of policy makers. In fact, the heterodox stabilization programs implemented in Latin America during the second half of the 1980s—including the *Cruzado* plan in Brazil, the *Austral* plan in Argentina, and the *Inti* plan in Peru—were intellectually rooted in the notion that devaluations were highly contractionary.

After some years of (relative) neglect, the issue of contractionary devaluations was revived in the late 1990s and early 2000s as analysts considered alternative “exit strategies” out of (pegged) exchange rate-based stabilization programs. In particular, authors who followed Argentina's experience with a currency board asked themselves what would be the effects of abandoning the peg on the country's economic activity, including employment and growth.

Most analysts who have focused on this issue during recent years have emphasized the role of “balance sheet” effects, which stem from the existence of foreign

⁵ A recent issues paper released at the IMF is a good starting point—see Prasad et al. (2003). On capital controls on inflows and contagion see, for example, Edwards (1999).

currency denominated liabilities. The argument works along the following lines: if domestic firms have debt denominated in foreign currency, exchange rate depreciation will generate a major increase in the (real) domestic currency value of liabilities. This, in turn, could contribute to massive bankruptcies, serious dislocation and an economic contraction—see, for example, Reinhart (2000).

However, the recent focus on “balance sheet” effects as the main contractionary channel, appears to be too narrow. Indeed, early theoretical work on contractionary devaluations, including an important paper by Van Wijnbergen (1986), considered two additional channels through which devaluations could generate contractionary forces. The first one is the existence of imported intermediate inputs. In this case, a devaluation will result in an increase in the cost of these inputs, generating an upward shift in the supply schedule for final goods. If this effect is strong enough to compensate the positive effect of the devaluation on exports, the net effect may indeed be contractionary. Van Wijnbergen’s (1986) second channel is related to the presence of a segmented domestic capital market—a situation that is still common in many emerging economies. In this case, a devaluation will increase the interest rate differential between the two segments in the capital market, reducing the overall availability of credit and, thus, increasing the cost of working capital. Once again, the final effect is an upward shift in the aggregate supply curve and a contraction in economic activity.

Whether these channels are indeed important empirically under the current institutional and structural settings of the emerging nations are an open question. It is, however, one that deserves to be studied in detail, if we want to understand more fully the effects of alternative exchange rate arrangements on output and overall economic activity.

2.3. Transmission of the international business cycle

Much of the disappointment with the reforms in Latin America stems from the slow pace of economic growth that the region has experienced during the last few years—mostly since 1999. Surprisingly perhaps, there has been limited effort devoted to understanding the international transmission of the business cycle from the advanced countries to the Latin American nations. And yet, it is perfectly plausible that much of the poor recent growth performance in Latin America is the result of external shocks, including the deceleration of the world economy since 2000, the deterioration in the region’s terms of trade, and the abrupt reduction in capital inflows. The importance of understanding this issue is quite obvious. If the deceleration of growth in (most of) Latin America is largely the result of external shocks, there are limited actions that domestic policy makers can undertake. On the contrary, if this were the case, rushing to discard the policies of the so-called “Washington Consensus” would be a mistake. On the other hand, if the recent slowdown in economic growth can be attributed mostly to domestic causes, it would be only reasonable to call for some changes in economic policy.

There are, of course, alternative ways of analyzing the issue of the international transmission of the business cycle. A simple and yet powerful approach consists of

regressing the cyclical component of growth in the country in question on the cyclical component of growth in the industrial nations, the terms of trade shocks, and the cyclical component of foreign capital flows. More specifically, this issue may be addressed by estimating equations of the following type:

$$\begin{aligned} \text{cycgrowth}_t = & \alpha_0 + \alpha_1 \text{cycgrowth}_t^* + \alpha_2 \text{tot}_t + \alpha_3 \text{cycflows}_t \\ & + \alpha_4 \text{cycgrowth}_{t-1} + \varepsilon_t, \end{aligned} \quad (2)$$

where cycgrowth_t is the cyclical component of domestic growth; cycgrowth_t^* is the cyclical component of world's (or industrial countries') growth; tot_t is a shock to the terms of trade, defined as the percentage change in the terms of trade (where a positive value is a positive shock); cycflows_t is the cyclical component of international capital flows as a percentage of GDP to the country; ε_t is an error term assumed to have standard properties; and the α s are parameters to be estimated. Naturally, since cycflows_t may not be a totally exogenous variable, Eq. (2) should be estimated using methods that allow for endogeneity. As an illustration, consider the case of El Salvador, a country that has been praised as a stellar Latin American reformer—second only to Chile—but whose rate of growth during the last few years has been exceedingly disappointing. Indeed, after averaging 6.5% per annum during 1992–1996, the rate of growth of El Salvador has been only 2.5% per year during the period 1997–2002. The estimation of Eq. (2) for 1960–2002, using a General Method of Moments (GMM) procedure yielded the following results (t -statistics in parentheses):⁶

$$\begin{aligned} \text{cycgrowth}_t = & -0.003 + 0.541 \text{cycgrowth}_t^* + 0.040 \text{tot}_{t-1} \\ & \quad \quad \quad (-1.05) \quad \quad \quad (3.30) \quad \quad \quad (3.08) \\ & + 0.268 \text{cycflows}_t + 0.050 \text{cycgrowth}_{t-1} - 0.007 \text{D8089} \quad (3) \\ & \quad \quad \quad (1.81) \quad \quad \quad (0.36) \quad \quad \quad (1.36) \end{aligned}$$

$R^2 = 0.333$, D.W. = 1.324, where cycgrowth_t^* was defined as the cyclical component of US growth, and D8089 is a dummy variable for the decade in which El Salvador was immersed in a civil conflict. As may be seen, the results are quite suggestive and indicate that a little over one half of the cyclical growth variations in the US growth is translated into cyclical changes in GDP growth in El Salvador. Indeed, according to these results a 10% decline in the terms of trade will be translated into almost one quarter of a percentage point decline in the cyclical component of growth. Also, a drop of capital inflows of one percent of GDP results in a decline in El Salvador's growth in roughly one quarter of a percentage form. Simulations based on this regression analysis suggest that these three shocks explain an important part of El Salvador's slowdown in growth:⁷ for 2002, these simulations indicate that negative shocks can account for 2.4 percentage points in

⁶ The following variables were used as instruments: One and two period lagged values of the exogenous variables, and the cyclical component of capital flows to the rest of the (large) Latin American countries. Results from the estimation of structural VARs for the case of El Salvador produce similar results.

⁷ These simulations assumed that the cyclical component of the US stayed at its 2000 level, that the terms of trade remained at their 1999 level and that capital inflows stayed at their 2000 level.

the country's growth reaction. This is a large number, and suggests that in the absence of these shocks El Salvador would have posted an average rate of growth of 5.5% in 2001–2002. This simulated rate of growth is significantly higher than the actual rate during the period, indeed suggesting that once world economic conditions improve, there will be an important recovery of the Salvadoran economy.

From a policy point of view, the results for El Salvador discussed above are particularly important. They suggest that undoing the market oriented reforms, as has been suggested by the increasingly powerful opposition party FMLN, may be a serious mistake that would have costly long-term consequences.⁸

Research geared at better understanding the empirical aspects of the international transmission of the business cycle should also focus on whether the transmission mechanism is different under alternative exchange rate regimes, and whether the mechanism itself has changed as a consequence of the reforms. Indeed, while the proposition that real external disturbances are better absorbed under floating regimes is very old in economics, there has been almost no empirical work on the subject. For example, in a comprehensive study [Hadass and Williamson \(2001\)](#) have reviewed most of the empirical literature in terms of trade and economic performance produced during the last five decades. They convincingly argue that, while there has been massive amount of work trying to explain the actual behavior of the terms of trade, relatively few studies have focused on the ways in which shocks to the terms of trade affect growth. And none of the studies reviewed by them makes a distinction between countries with different exchange rate regimes.⁹

3. Lessons from history

Latin America's economic history is extremely rich and is replete with valuable policy lessons. Yet, policy makers in the region have a tendency for ignoring them, and for repeating mistakes from the past. For example, current debates on the (in)effectiveness of exchange rate adjustment in the presence of massive dollar-denominated liabilities have tended to ignore the lessons from some key historical episodes. In particular, Chile—the undisputed success story of market oriented reforms in the world—offers important historical lessons on how a country that was once trapped in dollarized liabilities was able to survive a major devaluation, and make a successful transition towards exchange rate flexibility.

Starting in 1978, and in the midst of a stubborn inflation, Chile embarked on an exchange rate-based stabilization program. In June 1979, and after a brief period with a preannounced rate of devaluation, the nominal exchange rate was pegged at 39 pesos per dollar. At that time the authorities stated that this new fixed exchange rate would be in effect for the “indefinite” future.¹⁰ The architects of the program

⁸ On May 1st 2003, the opposition FMLN announced that if they get to power in 2004 they would go back, among other things, on the dollarization policy implemented in 2000.

⁹ [Broda \(2001\)](#) is a lonely exception.

¹⁰ During the first phase of the program, the nominal exchange rate followed a preannounced sliding scale. The rate of devaluation was deliberately set below the ongoing rate of inflation. See [Edwards and Cox Edwards \(1991\)](#) for details.

expected that a predetermined exchange rate would rapidly reduce inflation through, at least, two channels. First, in an open economy a fixed exchange rate would impose a ceiling to tradables inflation; second, the new exchange rate policy was expected to generate a major break in inflationary expectations and in inflationary inertia.

Inflation was reduced, but at a significantly slower pace than the authorities had anticipated. As a result, starting in 1978 the country experienced a rapid real exchange rate appreciation, which greatly reduced the country's degree of international competitiveness. Also, between 1978 and 1981 Chile received massive capital inflows that helped finance increasingly large current account deficits—in 1981, the current account deficit exceeded 12% of GDP. Throughout this period, and in order to reduce their cost of capital, firms of all sizes borrowed heavily in dollars. These dollar denominated loans, in turn, were intermediated by local banks that borrowed internationally.

By late 1981, however, two things had happened: first, the extent of exchange rate overvaluation had reached extremely painful levels. And second, corporations' balance sheets had become highly dollarized. What made this situation particularly risky was that borrowing in dollars had become the norm both for firms that produced tradable and non-tradable goods.¹¹

During 1982 the international financial community became increasingly concerned about the growing current account deficit. As a result, loans were recalled and capital flows dried up rapidly. In fact, it is not an exaggeration to say that this episode constitutes the most impressive case of a “sudden stop” of external financing in a modern economy. By mid-1982 conditions had become unsustainable, and in June the fixed exchange rate was abandoned. The devaluation could not be contained, and by the end of the year the exchange rate had shot to 74 pesos per dollar. The corporate and the banking sectors were severely affected, and a large number of firms went bankrupt. Unable to collect on their loans, a number of banks became insolvent and had to be bailed out by the government. The immediate effect of these events on output was devastating. In 1982 GDP declined by 14%, and in 1983 it dropped by a further 1%.

Starting in 1984–1985 a massive program aimed at recapitalizing firms through debt–equity swaps was put into place. At the same time, the government implemented a managed exchange rate policy geared at maintaining a “competitive” real exchange rate. The Central Bank policy targeted real interest rates, trying to maintain them at a “reasonable level,” and fiscal policy generated an overall surplus. The privatization of the social security system gave a boost to the domestic capital market, and the economy was opened to further international competition. The existence of indexation in the financial markets allowed firms' to borrow long-term in (real) pesos, thus avoiding dollar denominated loans. By 1987 the economy had fully recovered and in the decade that followed Chile grew at an average of 8% per year. This splendid performance allowed the country to reduce poverty by one

¹¹ The construction sector was a major recipient of dollar-denominated loans.

half, and to experience massive improvements in social conditions. To be sure, the costs of the crisis were very high in 1983–1984, but there is little doubt that they were more than offset by the subsequent spectacular performance of the economy.

Naturally, the lessons from Chile cannot be translated in a mechanical way to other countries. But what the episode does show quite clearly is that even in a highly dollarized economy subject to balance sheet effects—and Chile was the mother of all balance sheet effects—there is life after a devaluation. Moreover, in this particular case the quality of this post-pegged exchange rate life was excellent.

The historical episode discussed here is but one of many useful ones in Latin America. Researchers would do well by turning towards them, and by researching how the experiences of the past can help illuminate policy makers and analysts on the complexities of the present.

4. Concluding remarks

More than a decade after the market-oriented reforms were launched, there is deep pessimism among Latin America watchers. Many analysts believe that there is a new political trend in Latin America, and that the region is on the brink of a populist revival. Some observers argue that anti-market government actions in Argentina, Venezuela and Uruguay are clear evidence that populism is back with a vengeance. They foresee an outburst of inflation, a backtracking of the market-oriented reforms implemented during the last decade, the nationalization of public utilities, the repudiation of the public debt, and a steep increase in protectionism.

This generalized gloom is not justified, and misses the subtleties of the economic and political dynamics in the region. Moreover, it is based on gross generalizations that ignore Latin America's rich diversity and heterogeneity. Different countries have different histories and traditions, and move at their own pace. Flirtation with populism in some of them does not mean that the region as a whole—and not even the majority of countries—will follow the path towards economic heterodoxy.

Nowhere in Latin America—and certainly not in the large countries, Brazil and Mexico—are people clamoring for a return to the days of galloping inflation. And people remember with horror the time when the government heavily regulated their lives, and when populist promises vanished in the midst of corruption and inefficiencies. On the contrary, today more people than ever value economic freedom, and support a democratic political system.

It is true, however, that voters across the region are fatigued with the pace of reform, and are deeply concerned with the lack of economic growth during the last few years. Politicians want to take a “time out” and re-evaluate their countries' development strategies. In some countries there is concern about rising unemployment, while in others issues related to the provision of social services, including health and education, are at the forefront of the discussion. In very few, however, is the “official” position one of nostalgia and populism. But even in those countries, the anti-market sentiment is far from generalized, as it has been illustrated by

the increasing rejection of President Hugo Chavez statist and interventionist policies in Venezuela.

There is an increasing sentiment among the Latin American public, however, that the region has done more in terms of reforms than the advanced countries. Take, for example, the case of international trade and protectionism. Since the early 1990s the Latin countries have made tremendous progress in eliminating trade restrictions, slashing import quotas and lowering import tariffs. As a result, the region has become a major market for US, European and Asian products. While only fifteen years ago it was difficult to find US made products in Latin American supermarkets or department stores, today Latin consumers have access to the same products as their US counterparts. But Latin America has not only opened up to imports of manufactured goods, it has also liberalized its financial sector, allowing international banks and insurance companies to do brisk business throughout the region. In contrast, the advanced countries have become more protectionist during the last few years. The US has imposed tariffs on products such as steel, and has massively increased agriculture subsidies; Europe continues to protect heavily its agricultural sector, making it increasingly difficult for Latin exports to find their way onto European consumers' tables.

It is too early to know whether this sense of “unfairness” in trade will be eventually translated into serious reform backtracking. To a large extent that will depend on the advanced countries themselves. Policies in the US and Europe that promote true free trade and allow Latin agricultural commodities and other exports to reach markets would go a long way towards finally defeating the specter of populism in Latin America.

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