Economic Policies in Emerging-Market Economies: An Overview

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Economic policies in emerging-market economies (EMEs) are shaped by the structural features and policy challenges of countries on their road to development. Convergence toward income levels of advanced countries is a difficult and bumpy road—it is even uncertain if and when most developing countries will overcome the middle-income trap—and EMEs differ in their particular conditions and progress toward development. Yet they face common issues and policy challenges that require systematic analysis. This volume addresses a selective number of key policy questions relevant to EMEs in the fields of macroeconomics, financial integration, and economic development.

This volume is a Festschrift that honors the life-long academic and professional achievements of Professor Vittorio Corbo Lioi. It comprises original scientific contributions by scholars, researchers, and friends that reflect their generosity and admiration for Vittorio Corbo. The twelve chapters of this volume are revised versions of the papers presented and discussed at the Conference in honor of Professor Corbo, organized by the Instituto de Economía of Pontificia Universidad Católica de Chile, in Santiago on 27-28 October, 2011.

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(University Provost), Francisco Rosende (Dean of the School of Economics and Business Administration), and José Miguel Sánchez (Director of the Institute of Economics) gave their support to and participated actively at the Conference. We thank the corporate sponsors of the Conference and their board members and executives —Mauricio Larraín (Banco Santander), Andrés Castro (AFP Capital), and Álvaro Donoso (CorpBanca)—for their personal commitment to the Conference and the generous financial support provided by their corporations. We are also indebted to the Conference's excellent production team comprised by María de los Ángeles Ferrer, Macarena Montiel, and Carolina Gallegos.

Special thanks go to chapter authors that generously gave their intellect and their time to the success of the conference and this Festschrift by contributing excellent original research. We also thank paper discussants, session chairs, and conference participants for their valuable contributions.

We also thank warmly the Board and the staff of the Central Bank of Chile for including this Festschrift volume in the Bank's Book Series on "Central Banking, Analysis, and Economic Policies".

This Festschrift opens with a *Laudatio* in honor of Vittorio Corbo by Klaus Schmidt-Hebbel and closes with Professor Corbo's *Curriculum Vitae.* In between are the research chapters, organized around five major areas that are at the core of Vittorio Corbo's research and professional involvement.

The book's first chapters focus on two key dimensions of development thinking and policy. Anne O. Krueger, in her keynote lecture, derives the implications of rapidly growing EMEs for the world economy. Trade is a major growth engine, as reflected in the rising share of developing countries in both world exports and GDP. However, as argued by the author, the role of developing countries in general (and high-growth EMEs in particular) has oscillated between heterodox criticism, opportunistic silence, and free ridership of industrial countries' efforts toward liberalization of international trade and capital flows. Therefore Krueger calls for a more active and constructive role of EME governments and economists in supporting open markets for goods, services, and capital, attaining international agreements on migration and environmental protection, and strengthening multilateral institutions. This would be both in their interest and that of the world at large.

Sebastian Edwards' contribution on the war of ideas in development reviews the policy debates that have shaped economic thinking and development policy during the last 50 years. He reviews the dominance of the planning approach to economic development from the 1950s to the 1970s, based on protectionism, forced industrialization, and government control. In the 1970s and 1980s, the planning approach suffered the double blow of its large-scale failures in most developing countries and the intellectual challenge posed by a growing number of economists and policy makers that espoused the market approach to development. The latter became the dominant development paradigm for most developing countries, since the 1980s and to date. A more specialized and still ongoing debate is between the supporters and the critics of foreign aid. Here, and regarding public policies in general, the author favors using randomized control trials to evaluate policy effectiveness, moving current and future policy debates from abstract thinking or aggregate assessment to the reality of field experiments and their statistical evaluation.

The volume's second part develops new interpretations of the recent global financial crisis, focusing on financial markets, capital flows, and financial (in) stability. Ricardo J. Caballero derives a stylized model of the workings of a global economy where one of its key driving factors is economic agents' continuous struggle to find assets in which to park financial resources. This struggle naturally comes with euphoria and disappointments, as many of the "parking lots" are built too quickly, are not of the desired size, or suddenly collapse. There are also global asymmetries, as some countries are endowed with more empty "land" than others, and their growth potential may also differ. The author uses this caricature of the world economy to describe several of the main driving forces behind recent global macroeconomic events, such as the steady decline in real interest rates, the spikes in risk spreads during the subprime crisis, the pattern of global capital flows between EMEs and industrial economies, or the struggles of the European periphery, and to explain the role played by "quantitative" easing-type of policies in this environment of (safe) asset shortages.

Guillermo Calvo shows in the following chapter that liquidity considerations provide a simple rationale for the creation and destruction of bubbles, and related disturbances in credit markets—the fall in collateral values, in particular. He presents a framework in which credit disturbances can explain jobless recoveries and involuntary unemployment. Jobless recovery follows from the assumption that job creation is at a disadvantage with respect to physical capital investment projects, because the latter come with their own collateral. Involuntary unemployment arises because, due to severe working capital constraints, the full-employment real wage would ravage work ethic to such an extent that firms find it more profitable setting their wages above the full-employment level —even though nominal wages are perfectly downward flexible. The model does neither rely on Keynesian rigidities nor on the absence of a lender of last resort to explain protracted recessions with large involuntary unemployment, such as those following deep financial crises. The key is liquidity creation and meltdown.

Alberto Martin and Jaume Ventura offer new insights on the relation between financial reforms and capital flows. Due to debt enforcement problems, many high-productivity firms in EMEs are unable to pledge sufficient future profits to their creditors and this constrains the funding they are able to obtain. Many argue that, by relaxing these credit constraints, reforms that strengthen enforcement institutions would increase capital flows to EMEs. However, this argument is based on a partial-equilibrium notion, which does not take into account the origin of additional resources that flow to high-productivity firms after the reforms. The authors show that some of these resources do not come from abroad, but instead from domestic low-productivity firms that are driven out of business as a result of the reforms. Indeed, the resources released by these low-productivity firms could exceed those absorbed by highly productive firms so that capital flows to emerging economies might actually decline following successful reforms. This result provides a general-equilibrium perspective on some recent patterns of capital flows in industrial and emerging economies.

The following part of this book is on fiscal policy and fiscal regimes. William Easterly identifies growth slowdowns as one of the important causes of rising debt to GDP ratios and subsequent debt crises, as confirmed by some simple arithmetic borne out by recent experience in the U.S. and Eurozone, in middle-income countries in the 1980s, and in Highly Indebted Poor Countries (HIPCs) in the 1990s. It follows that preventing debt crises requires sound forecasting practices on future growth, such as projecting regression to the mean and making growth forecasts more conservative as the debt ratio to GDP gets higher. Unfortunately, political incentives often result in the opposite forecasting practices. The author provides examples from HIPCs and the U.S. that show growth forecasts getting more rather than less optimistic, perhaps to avoid confronting the need for difficult fiscal choices.

In recent decades a rising number of countries have adopted fiscal rules that constrain policy discretion with the aim of strengthening macroeconomic stability, fiscal sustainability, and resilience to government corruption and private lobbying. Ibrahim Elbadawi, Klaus Schmidt-Hebbel, and Raimundo Soto address empirically the question of why do some countries adopt and stick to fiscal rules while others do not. Their evidence, based on a large cross-country panel dataset, suggests that a dozen variables grouped in five sets of potential factors lead countries to adopt and hold to fiscal rules: more developed political institutions (democracy, federalism, checks and balances, and government stability), more sound fiscal policy conditions, particular monetary and exchange rate regimes (inflation targeting, fixed exchange-rates), financial development, and overall economic development.

Patricio Rojas and Félix Berríos analyze a puzzle related to the behavior of Chile's exchange rate. Adoption of a fiscal rule since 2001, which links government expenditure to long-term prices (and delinks it from current prices), should have reduced the high correlation between the price of copper (Chile's main export) and the exchange rate. However, this has not been observed. The authors address this puzzle by providing new evidence on several fundamentals that determine Chile's nominal and real exchange rates. First, they show that implementation of the fiscal rule has indeed reduced the impact of the copper price on the real exchange rate. Second, they provide evidence of other channels that explain why a higher price of copper appreciates the nominal exchange: higher prices of non-copper exports, improved expectations about global conditions affecting Chile, and higher domestic spending.

Part 4 of this book focuses on monetary policy and the exchange rate. Giancarlo Corsetti and Paolo Pesenti show that a monetary union (or a fixed exchange rate) can be perceived as an optimal policy regime, even if monetary unification does not foster real economic integration and intra-industry trade. In their model, firms choose the optimal degree of exchange rate pass-through as to stabilize markups in the face of real and monetary shocks. Monetary authorities choose optimal policy rules conditional on beliefs about firms' pass-through. Because of the interaction between these choices, there exist two equilibria. In the first, firms preset prices in domestic currency and let prices be determined by the law of one price, while floating exchange rates are optimal. In the second equilibrium, firms preset prices in consumer currency, and a common monetary policy is the optimal policy choice for all countries, leading to higher business cycle synchronization across countries but not to a superior welfare outcome.

Francisco Rosende and Matías Tapia study Chile's 30-year road to low inflation. They provide evidence that Chile's successful stabilization, in a context of strong domestic growth, reflects both better domestic policies (in terms of objectives and actual policy management) and a favorable global supply shock that reduced inflation everywhere. Using structural break methods, the authors find that the inflation process has changed twice since 1977; both changes coincide approximately with relevant changes in domestic monetary and international conditions. Next they compare the statistical pattern of Chile's disinflation with those exhibited by G7 countries, confirming strong similarities between Chile and industrial countries regarding the timing of disinflation and the breaks in trend inflation and inflation volatility.

The final part of this volume is on economic growth, poverty, and trade policy. Humberto López and Luis Servén provide a direct empirical assessment of the impact of poverty on growth. The paper's strategy involves including poverty indicators among the explanatory variables in an otherwise standard empirical growth equation. Using a large cross-country panel dataset, the results show that poverty has a negative impact on growth that is significant both statistically and economically. This result is robust to a variety of specification changes, including different poverty lines, poverty measures, sets of control variables, and estimation methods, as well as allowing for linear and non-linear effects of inequality on growth. Further, at low levels of financial development, the adverse effect of poverty on growth works through investment. Hence financial market imperfections are a key ingredient of poverty traps.

José I. Cuesta, Francisco A. Gallego, and Felipe A. González assess the local effects of trade opening in Chile, exploiting the fact that municipalities differed strongly in effective rates of protection before the start of trade liberalization that made import tariffs low and uniform. Using a novel dataset from agricultural censuses over a period of 50 years, the authors find that agricultural output and specialization increased more in counties that started with negative effective rates of protection. In turn, average plot size, land concentration, and poverty rates declined in municipalities that had relatively more distorted prices before economic liberalization. Finally, although production declined in counties where effective protection fell, poverty did not increase more in these areas, which suggests that other activities developed there.