

THE POLITICAL ECONOMY OF REFORMING DOMESTIC FINANCIAL ARCHITECTURES

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Introduction

This paper examines the political economy dimensions of building domestic financial architectures in developing countries that are more immune to recurrent crises and that contribute to high-quality and lower-volatility growth. One way of appreciating the importance of the issues is to note the effects of macroeconomic and financial crises on the incidence of poverty.¹ Between 1993 and 1995, Nigeria went through an economic downturn associated with a banking crisis (see the study by Ajayi and Adenikinju in this volume). Per capita GDP declined every year, by an average 1.3%. In 1992, just before the crisis, the incidence of poverty had been estimated at 43%, using a nationally defined consumption threshold. This level represented a reduction of three percentage points with respect to the previous available measure (1985). After the 1993-95 downturn the comparable headcount ratio was 66% (UNDP, 2004). Taking the 1992 level as the benchmark, Nigeria would need to bring such ratio to less than 22% by 2015 to meet the respective Millennium Development Goal; that is, poverty would have to fall by approximately 0.9 percentage points per year. In contrast, from the 1996 level, the required yearly reduction to achieve the same target would be 2.3 percentage points (two and a half times the pre-crisis speed of reduction). Or, put differently, at the pre-crisis speed, the MDG poverty incidence level would not be achieved until 2040.²

This paper aims to illuminate the extent to which aggregate economic volatility and its structural correlates affect the capacity of developing countries to build development-friendly domestic financial architectures (DFAs). The issues as just posed reverse the logic of the biggest part of the literature on institutions and economic outcomes: rather than analyzing institutions primarily as an exogenous factor that contributes to determine economic performance, this paper –without minimizing the influence of institutions on

¹ Caprio and Klingebiel (1996) provide estimates of other economic costs of recent financial crises. Leijonhufvud (2003) discusses the much broader social implications of crises.

² Specific estimates are different with the international poverty definitions used by Chen and Ravallion (2004), but the direction of changes and the substantive conclusion are the same (see <http://iresearch.worldbank.org/PovcalNet/>).

economic outcomes—looks more in depth at the opposite hypothesis that macroeconomic volatility affects a society’s capacity to build institutions for high-quality growth. If the hypothesis is supported by the evidence, it may open new windows on the debates about national and international responses to that challenge. In fact, the predominant views of the requirements for financial and macroeconomic stability rest on the assumption that dysfunctional institutions and inadequate public policies existing in developing countries explain the weaknesses of their financial systems, which in turn make their economies more volatile, more prone to crises, and less able to grow consistently. The challenge for these countries, therefore, is to build the “right” institutions and adopt “correct” macro policies –and designing and implementing these would be primarily a technical problem.³ This approach, however, suffers from at least three major shortcomings.

First, the conventional causal framework tends to neglect the political-economic underpinnings of institutions and policies. The literature on economic policy reform shows that technically sound –even Pareto-improving— policy and institutional changes may not be pursued because they would destabilize a political-economy equilibrium that has allowed powerful groups to thrive.⁴ This would apply in particular to the basic institutional infrastructure that supports a financial system as well as to the policies that define the broader environment for financial transactions. In this light, technically sound innovations may not be adopted not because policy makers do not know about them or cannot see their direct benefits, but because they may rightly perceive them as having broader or other indirect distributional impacts and potentially creating “dysfunctional” instability in other realms of the political-economic process (Fanelli and McMahon, 2006, provide historical examples and a conceptual discussion).⁵

The second shortcoming of the prevailing approach to financial systems, crises and growth is the narrow definition of the relevant set of institutions and policies. In this

³ See, for example, Krueger (2003).

⁴ Sturzenegger and Tommasi (1998) includes some of the seminal theoretical contributions and applications of this concept to macroeconomic policy analysis.

⁵ This is in stark contrast with the expectations of Krueger (2003), who asserts that “As the lessons of crisis prevention and management become more widely accepted and understood, it is to be hoped that the political pressures on governments to undertake sustainable policies will reduce the instances where crises do occur.”

regard, the literature could be roughly split in two. On one hand, there is the more conventional, open-economy macroeconomics literature, focusing on the choice of policy regime and the management of specific policy levers as key drivers of growth, stability and financial depth –Frankel (1999) could be a typical example. On the other hand, there is the literature that looks at the institutional determinants of financial development and its growth implications, or at the role of some relevant sub-sets of institutions –for example, the debates surveyed in Levine (2005), and Beck, Levine and Loayza (2000) on the finance-growth links. There is little dialogue, in fact, between these two relevant literatures, and this often yields prescriptions that are incomplete or inadequate.

The experience of developing countries, having to address simultaneously various institutional and policy challenges, and also the political economy approach favoured in this paper, make it advisable to define “domestic financial architectures” more broadly. With Fanelli (2006a), this paper includes in the definition both the institutional infrastructure for financial transactions (the legal and judicial institutions, regulatory frameworks, and other policies and practices affecting the financial sector, as well as the determinants of corporate governance) as well as the macroeconomic regime (i.e., the three constituents of the policy trilemma in open economies: exchange rate, capital account and monetary policies). The two are interconnected not only by how the conditions in one directly influence the performance of the other but also by more indirect political-economy effects. In fact, the distributional implications of the choices available to policy makers in one realm (e.g., the choice of exchange rate regime) are often mediated by circumstances in the other (e.g., the legal and broader institutional underpinnings of the degree of dollarization).

The DFA so defined would comprise the constellation of institutions and policies that have the capacity to mitigate or amplify volatility. However, the discussion above already suggests that the institutions and policies that make up the DFA can also be affected by volatility itself. This in fact is the third shortcoming of the prevailing approaches to financial and macroeconomic stability, which is that they typically neglect the effects of volatility on a society’s ability to adopt different institutions and policies. In this paper we

follow the analytical framework proposed by Fanelli (2006a), which explicitly recognizes the negative effects of aggregate volatility and crises on the quality of institutions and policies, and on the conditions for collective action to improve them. In such a framework, volatility and crises have a *direct* adverse effect on collective action by intensifying distributive conflict or inviting opportunistic behaviors. One of the stylized facts from the growing empirical literature on the political economy of reforms is that there is a negative relationship between instability (economic and political) and a society's capacity to make inter-temporal political compromises associated with reaching superior cooperative equilibria (Fanelli and McMahon, 2006). For example, unreliable access to international capital markets, and a history of costly crises with sizeable wealth and income redistribution, may lead a government to defend a currency (and exchange rate regime) beyond what would seem reasonable.⁶ Distributional conflicts, and the experienced or latent aggregate instability, thus postpone necessary adjustments, an expression of the inability for superior collective action.

Moreover, crises and volatility also undermine the institution-building efforts *indirectly* by making some risks non-contractible and certain policies unfeasible. This could be so as a result of dysfunctional policies adopted to cope with a previous crisis, or due to the adaptive responses by private sector agents to high volatility and excessive risks of capital losses (Fanelli, 2006a, highlights these as institutional "mutations" that create path dependence). When all this is taken into account, the reforms required to build functional DFAs appear as complex exercises in social innovation, requiring sustained efforts over several years and various rounds of upgrading. In such conditions, there tends to be a multiplicity of opportunities for organized interests to sabotage institutional reforms during their implementation, either by openly challenging formal rules or by developing informal rules that run counter the aims of the formal innovations (Rius and Van de Walle, 2005). The empirical political economy of economic reforms has shown that aggregate volatility only exacerbates these difficulties. In turn, derailment of reforms during implementation can further contribute to excess volatility. These political

⁶ See Fanelli (2006b), on Argentina's currency board; but also, strikingly, Caballero, Cowan and Kearns (2005) on Chile's response to the Asian/Russian crises.

economy dynamics and constraints acquire more significance if the excess volatility faced by developing countries is at least in part originated in structural features of their economies, or in the functioning of global markets under prevailing governance regimes –for example, if excess volatility can be shown to result from developing economies’ productive and trade specialization. Then, building more solid financial architectures may require more than recognizing and correcting narrowly defined domestic “policy mistakes”.

This article’s methodological approach was determined by the design of the larger initiative reflected in this volume. The chapter was expected to build on the country studies, highlighting and zooming in on the relevant evidence, and drawing a number of plausible theses and implications.⁷ This provides a main source of the paper’s strengths and limitations: while it has been possible to draw from fresh empirical analyses of the volatility-institutions nexus for eight significant developing and transition economies, it was not possible to dictate the contents of those country studies to provide the type of evidence that would have been required to test some of the attempted generalizations more rigorously. Because of this design constraint, the paper’s conclusions must be taken as indicative and subject to further investigation.

Four sections follow this introduction. The next three sections use selectively the evidence and narratives from the country studies to unpack and analyze elements of the hypothesis that volatility and crises undermine society’s capacity for collective action and institution-building, therefore having deleterious effects on DFAs. Each of the sections highlights a set of interrelated complications arising from the ‘excess’ volatility that characterizes developing economies: section one focuses on issues of timing and sequence of institutional innovation, section two discusses the scale of the institution-building challenges and the speed of economic processes, and section three examines the

⁷ For this reason, unless indicated, all the evidence on Argentina, Brazil, Chile, China, Nigeria, Russia, South Africa and Thailand comes from the studies that form part of the project. These are, respectively: Fanelli, J.M. (2006b), Pires de Souza, F.; Borges da Silveira, G.; Cardim de Carvalho, F. (2006), Magendzo, I.I. and D. Titelman (2006), Wu, H. X. and E. Shea, (2006), Ajayi, S.I. and A. Adenikinju, (2006), Popov, V. and A. Peresetsky, (2006), Ayogu, M. and H. Dezhbakhsh, (2006), Vichyanond, P. and P. Pholpirul, (2006).

links between the volatility of consumption and the socio-political conditions for architectural reform. The final section summarizes the main policy implications.

1. Timing and sequence

The country studies provide ample evidence that policy and institutional innovations affecting the DFAs follow patterns of *reactive policy making*. Indeed, the narratives on the evolution of the DFAs in those countries show that (a) there tend to be more innovations during and immediately after downturns and crises, and (b) there is a tendency to modify multiple policy instruments and institutions to meet macroeconomic policy goals during those periods. These patterns influence the timing and the sequence of innovations to the institutions that form the DFA, and have the potential to generate economically dysfunctional configurations over time.

Nigeria, for instance, introduced a large number of reforms to its DFA between 1986 and 1993, altering the functioning of currency markets, removing and later re-introducing barriers to entry to financial intermediation, reducing government controls over interest rates and relaxing bank portfolio restrictions, introducing new mechanisms in the market for public securities, and –latter in the period—tightening financial supervision and introducing prudential regulation. These followed four years of declining GDP resulting from a negative shock to the terms of trade, with average losses above 5% per annum (1980-83) that had not been offset by the modest growth in 1984 and 1985. The post-1986 reforms reflect the conditionality associated with financial assistance by the international financial institutions (IFIs) but, as it has been the case in other developing countries, the preceding crisis doubtlessly created local appetite and the conditions for comprehensive reforms. Twin balance of payments and financial crises –and structural adjustment programs agreed with the IFIs in exchange for assistance—also characterize the context in which comprehensive reforms were undertaken in many Latin American countries in the mid-1980s, including saliently the case of Chile discussed below.

In China, where no direct influence from IFIs occurred, the buildup of inflationary pressures in 1989 and in 1991-92 also provided the stimulus for economic reforms (Guo et al., 2005). Some of the innovations of the ensuing reformist ‘leaps forward’ contributed to re-shaping the DFA as discussed in Wu and Shea (2006) and below. In Argentina, the currency board regime, and the associated reforms to the charter of the Central Bank, the deposit insurance scheme, and the systems of financial regulation and oversight, all occurred in the brief period of two years immediately after the hyperinflation of 1989-90. Additional important alterations to the DFA took place in 1994-96, as a response to the slowdown in economic activity and other adverse domestic repercussions of the Mexican financial crisis. The Real Plan in Brazil since 1994—a comprehensive stabilization and structural reform program—was a response to uncontrollable inflation and a stagnant or declining economy in the previous years. Capital requirements were later increased in 1997 as a response to the crisis in Southeast Asia, and other consequential innovations affecting credit markets were introduced in the aftermath of the 1999 devaluation that sought to address external imbalances and a declining economy.

These patterns of reactive policy making have not been missed by scholars, nor are they exclusive to developing countries or to the reform of financial policies and institutions. In the 1960s, Albert Hirschman had examined the policy processes in developing countries and noted the difference between ‘pressing’ and ‘chosen’ problems. While the latter would be picked by policy makers as a result of their preferences and perceptions, the former would be those keeping them busy most of the time and “forced (on them) through pressure from injured or interested outside parties” (Hirschman, 1963; see also Meier, 1990). These are typically problems associated with a perception of crisis. More specifically, Hirschman observed that in the presence of balance of payments crises and severe foreign exchange constraints “the state loses its august character of sovereign pursuing its own objectives and initiating politics to this end; rather, it is seen as coping,

as best it can, with a variety of emergencies, as constantly plugging holes, and stopping a wheel from creaking by applying a bit of grease in a hurry” (Hirschman 1975:389).⁸

Empirical studies such as those by Paul Mosley (1976, 1984) suggest that reactive patterns of policy making are not exclusive to developing countries or to contexts of extreme volatility. He finds that a model of ‘satisficing’ behavior could account for the decisions of British and American administrations with regards to macroeconomic policy over extended periods in the XXth century. In his analysis, the authorities (i) acted in response to target variables surpassing ‘satisfactory’ threshold levels (or entering a ‘crisis’ range), and (ii) focused on one target at a time and used all available policy levers to restore that target to satisfactory levels (rather than following Tinbergen’s one-objective-one-instrument rule).⁹

A similar reactive pattern had been pointed out by analysts of the structural reform processes of the 1980s and 1990s. In an early study of the responses to the ‘debt crises’ of the early 1980s, Joan Nelson noted the widespread clustering and conflation of short-run macroeconomic stabilization measures and longer-term structural economic reforms in the aftermath of the crises, notwithstanding country-specificities with regard to pace, sequencing and broad policy orientation (Nelson, 1990; see also Stallings, 1990, on the longer-term recurrence of the reactive pattern, and Bresser-Pereira, Maravall and Przeworsky, 1993). These analysts also observed that IFIs have greatest leverage in post-crisis contexts, and that also shapes the nature of the responses.

That crises beget comprehensive reforms is also one of the most robust lessons from the most recent attempts to illuminate the political economy of policy change in developing and transition economies (Fanelli and McMahon, 2006). From a large number of analytical narratives, it comes up strongly that crises upset pre-existing political-

⁸ It goes on to say immediately: “Note that this conception of the coping state goes farther than the interest-group or bureaucratic-politics approaches; these are still concerned with improving our understanding of the state’s action, rather than with affirming that most of the time the state does not act, but reacts.”

⁹ Mosley draws inspiration from theories of bureaucratic organizations such as those by Cyert and March (1963), following the seminal work of Herbert Simon (1952).

economic equilibria and thus make it harder for the authorities to preserve the economic and institutional structures unchanged. The comprehensiveness of reforms, and the inclusion in reform ‘packages’ of innovations that appear to have little bearing on the causes or manifestation of the triggering crisis, is found by the authors to reflect the multi-layered nature of the policy making games, and the need to articulate new political economy equilibria.

Theory has not been oblivious to these empirical regularities. Some of the main attempts to develop models linking crises and reforms in a neoclassical, ‘New Political Economy’ framework are contained in Sturzenegger and Tommasi (1998). In these, a set of policies or institutions are abandoned or modified when the costs associated with maintaining them are greater than the costs of their change. Crises, by increasing the former, make reforms the rational response of policy makers and other agents whose acquiescence or support is required. The need to build credibility and signal commitment to the reforms is credited in some of these analyses with explaining the bundling of diverse innovations in reform ‘packages’.¹⁰

Alternative conceptual accounts of the reactive pattern of policy making are provided by the literature on the policy process and the behaviour of government bureaucracies. Rather than seeking to pin down costs and benefits that would be altered by crises, authors within these scholarly traditions tend to view policy makers as facing significant constraints on their time, resources, knowledge, and cognitive abilities, and as operating in environments where they must negotiate policy responses with a number of players. Under such conditions, they make “good enough” decisions by using rules of thumb and other heuristics that reduce the need to collect and process information (Simon 1976, 1987). Decision making also entails “muddling through” an interactive social process where different cognitive and political threads are intertwined (Lindblom, 1959; Lindblom and Woodhouse, 1993). Because policies develop out of ongoing interactions among groups of people and organizations concerned with a given issue (Kingdon, 1984;

¹⁰ Sturzenegger and Tommasi (1998) recognize that some of the models appear as ad-hoc attempts to fit theory to data, and that they are frequently not robust to slight changes in key parameters, or result in multiple equilibria and ambiguous predictions.

Sabatier and Jenkins-Smith, 1999), incremental change and trial-and-error not only become the norm but appear also as the best available alternative to impractical ‘analytical’ approaches to decision making. Most importantly, even though many of these authors partake in a view of individuals as capable of ‘boundedly rational’ choices, the reactive and satisficing behavior of complex organizations or whole governments can be sustained while remaining agnostic about the cognitive and decisional powers of individuals (Conlisk, 1996).¹¹

Regardless of their theoretical foundations and degree of sophistication, the ‘crisis theories’ of institutional innovation could be seen as having an element of tautology (Rodrik, 1996). In fact, given the uncertainties about lags and effectiveness of policy measures, why would *any* policy maker want to undertake ambitious policy change or attempt to reform prevailing institutions when things seem to be going well? On the other hand, it only seems logical that governments and other actors will try various institutional and policy innovations as a response to poor economic performance. The interesting conceptual complication comes, however, from the observation that the response to crises often involves the *bundling* of innovations with varying degrees of relevance to the problem at hand, or which may be thus adopted at the wrong time.

‘Inappropriate bundling’ may come as a surprise if policy changes are analyzed from a strictly economic angle.¹² However, it is hardly surprising when political economy considerations enter into the analysis. As suggested by Fanelli and McMahon (2006), specific institutional innovations that might appear ‘dysfunctional’ from a narrow economic perspective on the needs of the time, could be ‘functionally’ bundled with others in order to build winning coalitions or circumvent the power of veto players. If the objective function guiding policy choice places a premium on smooth trajectories, an externally-induced recession may not appear as the ideal time to tighten prudential regulation. However, this might be the ‘functional’ response to a pre-crisis liberalization

¹¹ Mosley (1976, 1984), for instance, attributes the determination and revision of threshold levels of satisfaction to negotiations within governments, and not to inherent cognitive constraints of individuals.

¹² Such was the logic under which the inclusion of trade liberalization in the response to the twin macroeconomic and financial crises of the 1980s could be said to represent a puzzle (D. Rodrik, 1996).

of the banking system that led to excessive and careless lending, or to the need to make public securities more appealing to financial intermediaries in the face of stubborn public deficits. Conversely, good aggregate outcomes such as high growth or healthy current account balances would not necessarily reflect strength of a financial system, but reforms that could make it stronger are often shunned during good times, in a similar apparent confusion about indicators, economic processes and policies. On top of their own internal dynamics, ‘inappropriate bundling’ could result from the interaction with the IFIs, which in recent decades have tended to use post-crisis interventions as opportunities to promote comprehensive reforms that go beyond the immediate needs of stabilization. In any case, the reactive bundling of reforms—a possibly ‘functional’ response to policy making under uncertainty and to political economy constraints—is likely to produce at least some innovations that are ‘dysfunctional’ or inopportune from a pure efficiency and stability point of view.

The country studies do show a number of instances of such apparently wrong timing and sequencing of institutional and policy changes. In 1996 the Central Bank of Nigeria responded to a recession and impending fears of devaluation by moving all public sector deposits from commercial banks to the Central Bank. While this may have worked to delay a devaluation, it did have the predictable short-term effect of further weakening the commercial banks’ financial position, and the longer-term effect of undermining agents’ confidence on the stability of the rules of the game. Many of the countries analyzed (in particular, Argentina and Brazil) increased capital requirements and/or tightened prudential regulations in other respects as a response to the East Asia financial crisis of 1997 and the Russian crisis of 1998. Thailand also tightened asset classification rules in the aftermath of its own currency crisis of 1997. These may seem as sensible conservative responses, but among their unintended (but also predictable) consequences were a rush to public debt that usually receives a more favorable treatment in such regulation, and therefore a crowding out of private borrowers under already deteriorating macroeconomic prospects. These measures were also taken in the presence of declining or negative net capital inflows, which amplified their contractionary effects. In all these cases, sound conservative measures had been typically eschewed during good times (i.e., under high

growth, generous capital inflows, and expanding private lending); and even existing regulations were often weakly enforced in those periods. Other examples of ‘coping’ policies with undesirable longer term effects include the introduction of exchange rate indexed bonds in Brazil after the 1999 devaluation, and the “Corralito” in Argentina during the 2001 breakdown of the Convertibility plan.¹³ The former is behind a process of ‘risk migration’ (Pires de Souza, Borges da Silveira, and Cardim de Carvalho, 2006) that forces the Brazilian government to choose between promoting financial and macroeconomic stability and stimulating growth; the latter is likely to have had durable effects on the confidence of Argentinean depositors in the banking system and the rule of law.

Problems of timing and sequencing are also evident when looking at some necessary changes to the DFAs that were *not* undertaken during apparently favorable periods. Typically, inadequate corporate governance, facilitated by incomplete or imperfect legislation (in particular with regard to disclosure and minority rights), as well as weak enforcement of contracts due to inexistent, ill-prepared or ineffective courts, all become apparent when countries are trying to find their way out of major financial crises or attempting to strengthen their financial systems. These problems are discussed in almost all the country studies in this volume, and are often present in public discourse in the countries in the aftermath of crises, but they are typically absent from policy agendas during booms.¹⁴ While it is easy to appreciate the wasted opportunities with the benefit of hindsight, this type of ‘mistake’ is not unusual or illogical when an economy is enjoying capital inflows and conditions seem to be improving significantly compared to the past. This type of dynamic can be seen, for example, when considering Thailand’s establishment of a stock exchange in the late 1970s and the financial liberalization of the 1990s. In the first case, there was a deliberate and careful gradual upgrading of transparency rules to allow market disciplines to operate, while in the latter there seemed

¹³ “Corralito” was the popular name for the freezing of bank deposits, and the compulsory conversion to Argentinean pesos of US\$-denominated ones.

¹⁴ Some analyses of the Argentinean experience in the 1990s, for example, highlight the neglect of reforms to critical legal, regulatory, administrative and judicial infrastructures, all these with a bearing on the functioning of markets and the determination and protection for property rights (see, e.g., Tommasi, 2002).

to have been no appetite for a gradual improvement of prudential regulations and supervision when capital inflows were abundant and investors were asking few questions in the face of generous margins.

The third section discusses some of the possible socio-political dynamics behind the reactive patterns. What is worth keeping in mind from the analysis so far is that institutional innovations and policy changes seem to intensify their pace during downturns and crises and that, under stress and through ‘bundling’, there is a tendency to cope with extreme macroeconomic outcomes by means of innovations that often deteriorate the quality of the financial architecture (i.e., innovations that make it harder for the financial system to play the role of buffer of shocks and channel of funding for high-quality growth). If, as shown by the country studies, adaptive responses of various agents cause many of the ‘bad’ innovations to become entrenched, countries that experience greater volatility and go through crises more often will tend to have poorer and harder-to-upgrade architectures. The success stories in the analyzed sample of countries also lend credence to the view that simple reactive adjustment to the DFAs constitute a trap that needs to be avoided: the countries that have escaped the stop-and-go cycles and have built more resilient financial architectures appear to have done so by learning to maintain the reformist momentum during favourable times (or to use effectively the scarce and narrow windows of opportunity to build *economically* functional architectures).

That is what the study on Chile in this volume shows, in line with other literature on that country (e.g., Stallings, 1990). In particular, the severe crisis of 1982 was followed by a ‘messy’ and costly clean-up process similar to that in other Latin American countries. However, in the second half of the 1980s, when some of the main costs had started to be absorbed and terms of trade were improving, several consequential reforms to the DFA were adopted: a banking law in 1986 introduced transparency, prudential regulation and measures to attack related lending, a Copper Stabilization Fund was set up in 1987, the Central Bank proactively pushed the substitution of the US dollar with an inflation-indexed unit of account in a deliberate attempt to curb dollarization, and public debt was

kept under control (Magendzo and Titelman, 2006). Moreover, other important DFA-improving reforms not called for by prevailing macroeconomic conditions were introduced in the 1990s and 2000s, in the face of high growth, favourable international capital markets and some occasional improvement in the terms of trade. Those included measures to regulate capital inflows (the ‘encaje’ and reserve requirements on short-term flows) and the adoption of a cyclically-adjusted target for fiscal policy. All these demonstrate a capacity to break with the reactive mode of policy making, introducing forward looking innovations that seem to have enabled the Chilean economy to cope better with external shocks in more recent times.

In brief, highly volatile countries are likely to have economically dysfunctional elements in their DFAs and to find it harder to reform them. These may not necessarily reflect lower levels of technical competence among their policy makers, but the specific conditions for collective action in high volatility environments. There are two important implications. On one hand, these countries need to ‘learn’ how to improve their institutional architectures under high volatility. This is likely to require creating conditions for enhancing cooperation and the management of social and political conflict (Fanelli and McMahon, 2006), something that transcends *economic* and *financial* institutions and involves the rules of the *political* game. On the other hand, measures to mitigate aggregate volatility—which might involve forms of international collective action—will not only be welfare-improving but would also have the added payoff of enhancing conditions for institutional upgrading. That is, there would be a *double dividend* from innovations allowing developing countries to smooth out their macroeconomic trajectories.

2. Scale and speeds

Various of the country studies in this volume demonstrate how human resource and other capacity constraints of public and private agents have contributed to the financial fragility in the recent past. In Nigeria, the authors blame the low quality of the banks’ portfolio,

during and after the liberalization of the late 1980s and early 1990s, on the inadequate expertise of bank personnel used to managing a limited range of financial instruments under stringent financial regulation. The attempt to bring the financial system to compliance with Basel standards since 1999 is also seen to have been hindered by the low human resource capacity in commercial banks as well as in the Central Bank and other oversight bodies. Similar observations are contained in the Thailand study, another example of rapid liberalization in subsequent waves, under less than optimal institutional and organizational conditions. The inability of the Brazilian banks and supervisory entities to fully implement Basel II standards, despite the size of the country's human resource pool and the revealed national technological capabilities, speaks once again of the complexities of the institution-upgrading involved in approaching internationally-sanctioned good practice.

The human resource constraints do not affect all agents in the same way, nor are they the only bottlenecks to be confronted. A new regulatory and supervisory framework demands new information systems and technologies, and is likely to lead to a necessary redesign of services, pricing policies and competitive strategies by financial intermediaries. Some country study authors also mention that certain services such as those provided by risk rating agencies are a precondition for market disciplines to work and these may take time to be domestically or externally supplied in developing or transition economies. Moreover, the studies show that the introduction or upgrading of prudential regulation imposes uneven costs on different financial agents. State vs. privately owned, domestic vs. foreign, large vs. small, or diversified vs. specialized intermediaries would be affected differently by more sophisticated or stringent regulation, requiring them different types of investments and testing their ability to adapt quickly. This could affect their competitive positions and destabilize a prevailing market structure with far reaching and partly unpredictable effects. The Nigerian study, for instance, draws attention to the fact that the pace at which new regulations are enforced would affect the capacity of locally-owned banks to compete with foreign ones, threatening the former with their possible disappearance. Those changes, in turn, could affect the access to financial services of various categories of non-financial agents. These processes would explain why, in

already financially challenged environments, and particularly during economic downturns –when, as we saw, the institutional upgrading is often undertaken--, the enforcement of sounder prudential and oversight regulation often advances slowly and selectively, or becomes itself a cause of undesirable upheaval. The multiplicity of direct and indirect impacts of DFA upgrading also creates opportunities for sabotage of the reforms at the implementation stage (more on this below).

The difficulties in aligning domestic legislation, regulation and the capacity of various government branches and agencies may vary depending on the initial conditions but are found to be significant everywhere. The Argentinean, Thai and Nigerian studies exemplify the implications of the inability to strengthen various pillars of the financial architecture coherently and simultaneously. Argentina, for example, emerged from ten years of relative macroeconomic stability with modest or no improvements in the investor protection legislation and the effectiveness of legal institutions (i.e., extent of the ‘rule of law’), which would account for the shallowness of equity and private bond markets and the short maturity of contracts. This is not to say that the reformers were unable to *see* the perverse effects of, e.g., legal loopholes and judicial practices that hindered the ability of lenders to recover their capital. Rather, the Argentinean experience shows how it might be possible to advance at very different speeds in formal and effective introduction of the enabling institutions, and how certain reforms (e.g., commercial law, the judicial system) may take many years to be on the political agenda of countries coping with wild macroeconomic swings, and even more to be pushed forward by willing and capable coalitions.

Similar institutional deficits seem to be responsible for the shallowness of the stock and corporate bond markets in Nigeria (or South Africa), and the disproportionate preference for government bonds and real estate as reserves of value. The thwarted experience of the creation of a stock exchange in Thailand in the early 1980s is also telling about how much easier it is to remove prohibitions or authorize new financial instruments versus establishing the necessary legal, judicial, organizational, and administrative supports for the sustainable expansion of a key pillar of a modern financial system. As suggested

before, many of the imperfections of a process like this can easily be obscured by the apparent success of the newly created markets under unusually favorable external conditions and generous capital inflows.

Important as they are in these countries with a relatively long history of market-based capitalism, the protection of investors, the enforcement of contracts, and the establishment of institutional frameworks to promote good corporate governance are among the most fundamental challenges confronted by the transition economies of China and Russia. Popov and Peresetsky (2006) give priority to macroeconomic policies in accounting for crises and volatility in the post-Soviet era but cannot deny that inadequate corporate governance and legal flaws associated with the transition to a market economy made it possible for some perverse and costly schemes (i.e., ‘financial pyramids’) to prosper in the weakly regulated and supervised Russian financial system. The greater reliance of firms on bank lending vis-à-vis capital market financing, the excessive number of banks, and the more general shallowness of financial markets, all seem to follow from the institutional incompleteness of an economy in transition from State-led communism to a market-based organization. Wu and Shea (2006) include the Marxist ideology and lack of market knowledge and experience as key factors explaining the piece-meal approach to reform in China, implying that gradual movement towards a market-based economy is often interrupted or reversed by various forms of administrative intervention. The result is a sui-generis form of capitalism (or socialism) where ‘corporate governance’ involves the ad hoc administration of state-owned enterprises by politically-appointed managers, and the financial ‘market’ is made up mostly of transactions between those firms and a few large banks that are similarly owned and managed. Excessive lending, borrower’s that confront soft budget constraints, non-performing loans, the emergence of informal banking, and politically-motivated bailouts are all of them observed (and predictable) outcomes of a DFA that could potentially become a destabilizing factor.¹⁵

¹⁵ “Without well functioning legal and bankruptcy systems or well established property rights and contracts that effectively support the rights of shareholders and creditors, ‘traditional corporate governance mechanisms’ have nowhere to take root in the Chinese economy” (Wu and Shea, 2006:37).

The literature on law, politics and finance has established that flaws in legal frameworks, judicial processes, and enforcement mechanisms, lead to uncertainty about property rights and to fears of expropriation, with a deleterious effect on the development of sound and functional financial markets (Beck, Demirguc-Kunt and Levine, 2001; Levine, 2005). The paper providing the analytical framework for this volume (Fanelli, 2006a) discusses the inter-relationships and mutual causation between the legal infrastructure and other components of a more broadly defined DFA which are typically neglected by that literature. In particular, it correctly emphasizes the path dependence created by perverse ‘mutations’ in institutional configurations, and by the agents’ adaptation of their strategies to the existing architectures. If those arguments were not enough to appreciate the scale and complexity of the reform challenge in volatile economies, a relevant branch of the law and finance literature has demonstrated empirically that economic outcomes are most decisively affected by the *effectiveness* of the law, as opposed to primarily the *contents* of legal texts. This highlights the role of non-codified or informal aspects of the legal infrastructure. Moreover, the evidence suggests persuasively that the process of legal development and the compatibility of the new laws with pre-existing conditions is a more important determinant of such effectiveness than the particular legal tradition from which a country borrows or inherits its institutions (Berkowitz, Pistor and Richard, 2003).¹⁶ This is so because the law is a ‘cognitive institution’ –only a few rules can be fully understood and enforced without reference to other legal terms and concepts, and the application and enforcement of rules is determined by the perception of new rules by users and enforcers in the receiving country–, and because effective law enforcement is a function of the extent of voluntary compliance as much as of the resources available in a given country (Pistor, 2002). Altogether, these results point in the same direction of the more encompassing view of the DFA espoused in this volume, and in particular highlight the role of informal institutions that result from the public and private agents’ adaptation to changes in legal texts or administrative measures.¹⁷ This further suggests that there are

¹⁶ These latter results apply in particular to the economies in transition, many of which have undergone large scale experiments in legal transplantation, guided by the goal of influencing economic outcomes and, in particular, of attaining financial deepening (Pistor, Raiser and Gelfer, 2000).

¹⁷ A sensible definition of informal institutions characterizes them as “socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels” (Helmke and Levitsky, 2004:9).

not easy fixes for ‘inadequate’ DFAs, and that their reform is bound to be a protracted process alternating incomplete advances and regressions in various interdependent domains.

The fiscal imbalances in large federal countries present additional complex and crucial sets of issues to the improvement of DFAs. Brazil, Nigeria and Argentina (and China in a different way) are shown to have struggled with such problems for many years. The studies clearly demonstrate that their capacity to manage them (or the lack thereof) has impacted directly on their ability to contain the crowding out of private borrowers by fiscally-challenged governments, and to eventually promote financial deepening. To appreciate the scale of the difficulties confronted by these countries it should suffice to consider that much more stable and prosperous countries such as Canada, that have devised complex fiscal arrangements for the management of federal relations and can rely on stable political institutions to work out the ever emerging inter-regional controversies, still cannot say that they have put the problems behind. Extreme regional inequalities, and the complex political dynamics associated with federal rule in weakly consolidated democracies, are likely to continue exerting destabilizing pressures on countries like the ones examined here.¹⁸

Table 1 below lists the components of the DFA, according to the definition adopted in this study, and some of the major challenges in upgrading them as identified by the country studies, with the aim to give a sense of the *scale* of the DFA-upgrading efforts.

¹⁸ Not all is dark and hopeless: the recent Brazilian experience, for example, shows that it is possible to find workable compromises between the center and the states; Nigeria is considering a fiscal responsibility bill in a time of terms of trade bonanza; and Argentina was able to revert many of the irrationalities that emerged as provincial responses to the 2001 financial, currency and fiscal crisis.

Table 1
**The scale of challenges in upgrading the DFA
in developing and transition economies**

<i>Component of the DFA</i>	<i>Selected major challenges</i>
<i>FINANCIAL INFRASTRUCTURE</i>	
Legal and judicial infrastructure	Legal appropriation, adaptation, customization Consistency with broader legal framework Establishing “legality” (effectiveness of the law)
Regulatory framework	Regulatory capacity (to formulate and enforce regulation) Tradeoff between competition and stability objectives
Policies and practices affecting financial sector	Direct and indirect effects on market structure and access to financial services Human resource and technological capacity deficits in Central Bank (or Superintendent agency) and in private sector
Corporate governance	Disincentives for disclosure Inexistence of rating agencies Incipient corporate/commercial law regimes
<i>MACRO REGIME</i>	
Exchange rate regime	Fiscal dominance (assoc. with fiscal federalism) and inability to borrow in domestic currency Currency mismatches in private sector
Capital account regime	Need to finance current account deficits as disincentive to ‘regulate’ flows
Monetary regime	Fiscal dominance (fiscal federalism) Loss of instruments

Addressing these institution-building and institution-upgrading challenges would take *any* modern and complex society substantial time. Moreover, the reformers may be able to introduce far-reaching innovations in a short period of time (e.g., in legal and

regulatory frameworks) but it may take time much longer for their full benefits to materialize (for instance, if there exist severe capacity deficits or if complementary informal institutions evolve more slowly). This paper argues, however, that highly volatile developing and transition economies confront two additional sets of complications.

First, new shocks and crises are likely to hit these economies *while* they are working on some of those institution-building challenges and *before* they have had time to correct the dysfunctional institutions inherited from the previous cycle. Such a complication would still be of a society's own creation if the destabilizing shocks were all domestically originated, but the country studies show a number of instances of the analyzed economies being hit by an externally generated shock before they could complete necessary reforms. That was the case of the Thai economy in 1983: pushed into a recession by an external shock while working on the institutional supports of a diversifying financial system, it could not cope with the loss of investor confidence and fell into a mini-financial crisis. In 1994, Brazil was hit by the Tequila effect when credit was starting to recover stimulated by the monetary reform and newly-acquired price stability; something similar happened again in 1997. The conditions were not better for Nigeria in 1993, when the structural reforms were starting to show their effect and it received a negative terms of trade shock that drove it to another recession and banking crisis. The reform of DFAs seems thus to resemble the dismantling of a complex explosive device, both in its difficulty and in the risks confronted by the 'fixer'. The complications added by high aggregate volatility could be assimilated to trying to do that on a boat, in the middle of a storm, and while a non-stoppable timing mechanism is ticking.

Second, the broader definition of the DFA that takes into account the interdependence of various institutional features and policies, entails reform agendas that inevitable touch on various domains and affect a range of agents and sectors of the economy. Large scale reforms, such as those required to upgrade complex DFAs, are bound to generate intricate, multi-layered, real-time distributive games, and will open numerous opportunities for the emergence of coalitions or powerful actors capable of sabotaging the

reforms at the implementation stage, or capturing the relevant bureaucratic bodies.¹⁹ The weaknesses of oversight and regulatory agencies, for example, makes it possible for segments of the private sector to circumvent formal rules through related-lending and other perverse schemes (Nigeria, Thailand, Russia). The fiscal dominance associated with distributive conflicts within federal states creates tensions between fiscal policy objectives (Argentina), or exchange rate management (Brazil), and the need to strengthen the banking system.

The resolution of conflicts and concentration of political activity at the implementation stage may in some cases result from the fact that policy choice in these countries tends to be less 'pluralistic' (Meier, 1990), either by the specific evolution of their political systems (O'Donnell, 1994) or because the 'choice' of reform priorities has been forced on the country by external conditionality and the imperative of foreign financial assistance. In any case, sabotage in implementation makes the outcomes of the reforms less predictable, thus contributing to the disappearance of markets that would enable more appropriate risk management, and undermining financial development. The success stories in the analyzed countries (Chile) also demonstrate the value of protecting oversight and regulatory bodies from capture, as a necessary complement to having the right configuration of laws and administrative codes in place. In brief, the studies in this volume expose institutional development challenges that volatility and crises only make less tractable by *reducing the windows of opportunity* for the resolution of complex collective action problems.

¹⁹ Rius and Van de Walle (2005), Fanelli and McMahon (2006).

3. Economic and socio-political volatility

When reading the country studies and related literature on the volatility of developing economies it would be appropriate to keep in mind the socio-political implications of their two better established stylized facts; namely, the extreme volatility of income and the even greater volatility of consumption. What these statistical regularities in fact imply is that a disproportionate part of the adjustment in these economies occurs through (or is directly reflected in) changes in the material well-being of their populations. Admittedly, many of the absolutely poor may benefit little from these economies' ups and therefore perceive not much change when their trajectories turn downwards. Also, the richest in these societies may have the capacity to shelter their assets from the instability, and some may even be capable of profiting from crises. However, the significant ups and downs mean *large portions* of the population see their fortunes directly affected, including many who may even experience dramatic losses of relative social status.²⁰ The volatility figures in the country studies mean that such changes of fortune occur frequently and are sizeable.

One could start to appreciate the political ramifications of such circumstances by linking them to findings from the extensive quantitative research on the association between economic conditions and political behavior. For much more stable societies, one of the classic studies (Erikson, 1989) had estimated that in the U.S., *ceteris paribus*, each one percent change in the annual growth of per capita disposable income would translate into a variation of the same sign of 2.8% in the incumbent's share of the vote.²¹ Ray C. Fair, in turn, has been updating econometric presidential vote equations that are alleged to have high predictive power, and shows in his latest estimate (Fair, 2004) a "growth" coefficient of approximately 0.7; that is, a one percent drop in real per capita GDP in the election year would reduce the vote for the incumbent by about two thirds of a percentage

²⁰ In an extreme manifestation of this, as a direct consequence of the recession and the financial crisis, 7% of the Argentinean active population became jobless between 1998 and 2002, almost 10 million people fell below the national poverty line and 6,5 million became indigent (cited in Kosacoff, 2005). The history of poverty reduction in China in the last three decades, in turn demonstrates by the opposite argument the social relevance of the macroeconomic trajectory (see, e.g., Chen and Ravallion, 2004).

²¹ Erikson used a discounted formula to average changes in disposable income over a presidential term, in which performance closest to the election time counts most heavily.

point. These could be seen as upper and lower bounds for the effect of macroeconomic performance on electoral behavior in a consolidated democracy whose economy is taken as a benchmark in the country studies.²²

For developing economies, Pacek and Radcliff (1995) estimated a significant effect of economic growth on vote for the incumbent. In fact, they find that positive growth has a statistically insignificant effect on vote shares, but negative rates of GDP growth do translate by slightly more than one-to-one into vote losses for the incumbent.²³ Karen Remmer (1991, 1993) had also shown previously that the crises in Latin American economies during the 1980s provoked electoral instability and turnover, with variations in exchange rates, GDP and inflation highly correlated with various indicators of electoral outcomes. Others (e.g., Villarreal, 1999; Posner and Simon, 2002) have found similar patterns when analyzing support for incumbent presidents using opinion polls. Some of the results could suggest that, having grown accustomed to live in unstable environments, developing country citizens would be prepared to discount a certain greater degree of economic instability as a fact of life. Yet, all the evidence would confirm that high economic volatility is likely to be associated with high *political* instability. The patterns would not be substantially different in post-communist countries, although they appear to be qualified by dynamics of ideological realignment and expectations about the impact of reforms on the political agenda (Przeworski, 1991; Doyle and Fidrmuc, 2003).

A recent resurgence of the economics of “happiness” (e.g., Frey and Stutzer, 2000) is providing complementary insights on the underpinnings of these political expressions, and qualifies the role of income vis-à-vis other economic variates such as employment or inflation (Berry, 2006).²⁴ With these results in mind, it is worth going back to the stylized

²² The controversies on the size and significance of the effects, as well as on their theoretical foundations, comprise a massive literature. Nannestad and Paldam (1994) provide a dated but analytically useful overview, including an attempt to establish the conceptual links between *vote* and *government popularity* equations. See also MacKuen, Erikson and Stimson (2002). MacKuen, Erikson, and Stimson (1992) and Norpoth, H. (1996), illustrate some of the main conceptual debates on the microfoundations of the established empirical regularities.

²³ The robustness of these ‘asymmetric’ effects has been a permanent source of controversy in the literature (Nannestad and Paldam, 1994).

²⁴ Employment (or unemployment) had revealed itself as a key concern and driver of voters’ attitudes and behaviors in post-socialist economies (Fidrmuc, 2000).

facts about highly volatile developing economies. In particular, the country studies show that aggregate investment is also more volatile than income. While this regularity is shared with more developed economies, the same pattern in economies with *extreme income volatility* must reflect more than the adjustment of desired investment levels to the business cycle by established firms, but also the interruption of whole investment projects and the collapse of large numbers of firms.²⁵ Visitors to some developing country capitals often get a sense of this through the number of unfinished construction projects that are in plain sight and with no visible activity. This is most apparent in the aftermath of a crisis but in some places it is still observable many years after.²⁶ What is worth highlighting is that the rocky pathway of investment is paralleled by a similar trajectory of *employment*. In a world where global competition has workers already worried about their job stability regardless of national average income or short term fluctuations, high volatility economies are going to be the scenario of dramatic manifestations of the political consequences of massive loss of jobs.²⁷

Considering those economic-political interactions, which are doubtlessly understood by developing country policy makers, it is not entirely surprising the way those authorities approach policy change and the reform of financial architectures. Wu and Shea, for example, argue that in China the concern with maintaining steady high growth to minimize political unrest often overrides the reform agenda and strengthens the hand of those favoring a centrally-controlled status quo. Those concerns are behind the manipulation of the exchange rate policy, the bailout of troubled state-owned-enterprises and banks, and the delays to reforms that would strengthen corporate governance and subject firms to market disciplines. Nigeria's Central Bank decision in 1996 to deprive commercial banks of government's deposits to reduce liquidity and avoid an impending devaluation, as well as the weak enforcement of prudential standards in more recent

²⁵ Leijonhufvud (2003) reminds us that financial crises normally lump the financially illiquid firms with the ones that were actually bankrupt.

²⁶ Flaws in the legal and judicial infrastructure that contribute to the shallowness of financial markets, are often to blame—directly and indirectly—for both the construction bubbles and the post-crises delays in clarifying property rights and allowing projects to resume.

²⁷ The fact that formal employment is a minority condition in poorer developing countries should not make these dynamics less relevant, as formally employed or modern sector workers often tend to be overrepresented in the political process.

times, would be similar manifestations of concerns about a looming crisis. A similarly casual approach to enforcement is mentioned in the Argentina case during periods under Convertibility when banks' non-performing assets, liquidity and solvency indicators were already worsening. In economies where all landings are rough, and where they hit populations that are definitely not wealthy by contemporary global standards, authorities are unlikely to be too enthusiastic about taking "slowly maturing" measures that could reduce growth or trigger adverse chain reactions, even if the seeds are being sowed of the next crisis.

A logically similar but apparently opposite pattern is manifest in countries that have recently come out of a crisis. There is little doubt, for example, that the left-of-center administration of President Lula da Silva in Brazil would have rather favored a more expansionary monetary stance had it not been persuaded of the risks of destabilizing an economy in which price, exchange rate, and interest rate hikes directly impinge on fiscal indicators and on the capacity to roll over debt. While its conservative, high interest-rate policies are to be thanked for consolidating price stability, which, to a great extent, has also benefited the poor, the country has not been fully isolated from political shocks or contagion effects (as argued by de Souza, Borges da Silveira, and Cardim de Carvalho 2006), and the monetary stance has stalled a much needed growth revitalization and employment creation. South Africa is another example of conservative policy making by administrations that would have been expected to prioritize growth and employment generation. The study by Ayogu and collaborators shows that, in the face of recurrent shocks and permanent fears of macroeconomic instability, the financial system remains under tight constraints (e.g., barriers to entry in retail banking preventing competition from stimulating financial deepening), and banks and funds are over-invested in government debt and in state-owned-companies.

Thus, a dual pattern of *fear of crises* (even fear of mild slowdowns, as in China) seems to reveal itself in the country studies, which determines suboptimal responses by policy makers to impending perils. It would lead to either myopic policy making to avoid fueling short term instability in pre-crisis contexts (Nigeria, Argentina, China), or over-

reaction by bullet-proofing financial systems that contribute little to the countries' growth objectives (Brazil, South Africa). In other words, the high volatility of income and consumption (and investment), and the resulting *fear of crises*, reinforce the reactive pattern of policy and institutional innovation that was characterized in section 1, and yield financially dysfunctional and harder to upgrade financial architectures.

The *fear of crises* is not unrelated to two other “fears” that have been identified in the literature, but the analysis here may suggest complementary explanations of observed policy responses. In fact, the original story about the “fear of floating” (Calvo and Reinhart, 2002) refers specifically to the management of exchange rates and emphasized—as a general analytical case—awareness by the monetary authorities of their policies’ lack of credibility. It also highlighted that devaluations in emerging markets tend to be associated with recessions, due to pervasive liability dollarization and to the predictable financial system repercussions of large swings in the exchange rate. Other reasons for the “fear of floating” are the high passthrough from devaluation to inflation and the adverse trade effects of exchange rate variability. Here, in turn, we do not unpack those relevant economic interactions but emphasize authorities’ concern about the known social repercussions of wild macroeconomic fluctuations, and in particular of employment and private consumption volatility. These would also suggest a low tolerance for exchange rate fluctuations and an interventionist reaction, but could perhaps account for a broader set of policy choices vis-à-vis the upgrading of DFAs. The *fear of crisis* hypothesis would seem to be more encompassing, as it would account for the response pattern of, for example, the Chinese authorities, for whom lack of credibility or some of the mentioned emerging market dynamics might still seem to be more distant concerns.

The more recent arguments about a “fear of sudden stops” (Caballero, Cowan and Kearns, 2005) do not neglect but deemphasize domestic economic processes, and bring to the forefront the policy makers’ concern about external sources of volatility. Specifically, comparing countries such as Australia and Chile, it is argued that those lacking in “currency-trust” and “country-trust” (i.e., Chile, in the comparison) would react more conservatively to terms of trade and financial shocks because of the worse domestic

consequences of similar shocks under poorer access to international financial markets. In conjunction with the “fear of floating” analyses, the two would be broadly consistent and supportive of the approach to DFAs that is espoused in this volume. They, however, pay less attention to the *political* repercussions of volatility, adopt a narrower definition of DFA, and therefore miss the volatility-collective action nexus (or the feedback effects).

The episodes of escapes (complete or partial) from the boom-bust cycle also reinforce the importance of mitigating consumption volatility to enable necessary reforms to DFAs. The experience of Chile after the 1982 crisis is one of a drastic fall in consumption volatility after the crisis, as much as one of a window of relative stability that was efficiently used to introduce forward-looking, creative and functional institutional innovations. In fact, the country study shows a steep decline in the volatility indicator for private consumption in the five to seven years after 1982. This appears associated with a more gradual and balanced revitalization of financial markets in following years, at a pace that would have given institutional and policy adjustments time to mature.

Yet, it must be remembered that Chile’s macroeconomic achievements in the 1980s were possible at an extraordinary social cost that has led some qualified observers to doubt that the experience could have been replicated in more open political environments. Meller (1991) recalls that unemployment was kept above 24% of the labour force for four years, real wages fell by 20% and were kept depressed for five years, and per capita social public expenditure was reduced by 10% over a period of six years. By comparison, it is worth noting that the volatility of consumption in Argentina actually increased in the five years after the parallel 1982 crisis, but in this case the political environment was of a transition to democracy in which popular demands were much harder to ignore by the newly elected government.

The Brazilian experience around the 1999 devaluation of the Real (and to some extent that of the Argentinean and Uruguayan mega-devaluations of 2001 and 2002) would show another instance of somewhat repressed consumption playing a role in the resolution of a macroeconomic crisis. In this instance, it was the unexpected low

passthrough from the devaluation to inflation, and the sluggish recovery of wages, that made it possible for the economy to rebound more quickly than in the past from the exchange rate hike, even without having introduced some of the institutional innovations that Chile managed in the 1980s. While completed fully under democratically elected administrations, the aftermath of the 1999 Brazilian devaluation may reveal underlying changes in the structure of labor markets and in the bargaining power of unions, that had made salaried workers less able to protect their real income during and after a crisis.²⁸ The episode illustrates another type of dynamic that, despite some apparent benefits, could not be easily reproduced elsewhere.²⁹ Chile in the 1980s and Brazil in the late 1990s in turn suggest that less painful stabilizations could have been feasible with appropriate supports from a different international financial architecture.

This leads to a reflection about *democratization*. Many if not all the analyzed countries are trying to upgrade DFAs under high volatility while simultaneously attempting to build or strengthen fragile democracies. If the significant social repercussions of volatility reinforce reactive patterns of policy making, superimposing the reform calendars that would be compatible with the economic cycles on the *electoral* calendars to which these polities are starting to adapt, should produce windows of opportunity for reformist policy makers that would be extremely narrow. While the economically-driven reform calendar would be determined by short-lived booms, the electoral calendar is known to yield also short-lived honeymoons of high support for the incumbent and cooperative play by key political actors.³⁰ An appreciation of these complications should further increase the value of international collective action to address the volatility problem. Those concerted efforts could be seen as helping developing countries to avoid the perverse choice

²⁸ Without neglecting possible political and ideological realignments, a greater openness of the economy to trade flows and the global emergence of low-wage giants (i.e., China) could help explain labor's loss of bargaining power.

²⁹ On the other hand, the 1999 episode also shows the benefits of appropriate innovations that were opportunely introduced. In fact, the Brazilian government's resolute action against currency substitution (i.e., dollarization) in the financial system can be thanked for avoiding a banking crisis associated with currency mismatches, which was very much the story of the Southern Cone crises of the 1980s and the more recent ones in Argentina and Uruguay.

³⁰ Almost all the empirical analyses of economic voting cited above also confirm that support for incumbents erodes gradually over time, even controlling for other relevant economic and political factors, and for both developing as well as developed economies.

between consistent and sustained reformist campaigns and upholding political democracy (see O'Donnell, 1994, 1995).

4. Some policy implications

The analysis so far should persuade that extreme volatility such as experienced by the analyzed developing and transition economies complicates the institutional reform challenges confronted by them. In other words, not only institutional failures may be responsible for high volatility but also such volatility alters the political economy of initiating, implementing, sustaining, and systematically upgrading, the institutional foundations of financial markets. That being the case, the menu of options for national and international collective action is expanded. In fact, developing countries not only would benefit from analysis, recommendations, conditionality and support to 'get their institutions right' but they could also use support – and should devise their own mechanisms—to make it through turbulent times with less aggregate fluctuations. Policies and coordination mechanisms that mitigate the volatility that these countries experience would yield a double dividend: they will produce the known direct economic gains associated with greater stability and growth (including welfare gains as well as the development of more sophisticated and deeper financial markets), and they will at the same time create the favorable conditions to tackle their enormous institutional challenges.

It is possible to be more specific about the policy and coordination mechanisms that could assist countries afflicted by excess aggregate volatility. First, the countries could benefit from all measures, national and international, that allow them to smooth aggregate income/output. For example, the cases analyzed clearly demonstrate –with success stories as much as with failures—the benefits of the diversification of exports by products and markets. The viability of such diversification obviously depends both on appropriate domestic policies and on progress in global and regional trade negotiations. It would seem that finance ministries in developed countries and particularly the IFIs would have

an interest in seeing progress on the latter, and some of the IFIs' analytical work points indeed in that direction. In a world in which financial markets have still not provided efficient mechanisms for managing idiosyncratic risk, allowing developing countries to diversify trade by products and currency should be a desirable second best strategy. The logical connection between more open trade regimes and diminished financial instability should perhaps be emphasized more strongly in the IFIs' and others' advocacy work.

At the same time, there would seem to be ample scope for improving the mechanisms for highly-specialized commodity-exporting countries to cope with inevitable terms of trade variability. While it may be harder to think of international coordination that could get rid of price volatility, these countries could use technical assistance in setting up appropriate fiscal and financial institutions, and there is—in this volume and article—a renewed argument for IFIs resuming more vigorously their traditional role of providing assistance to countries affected by adverse temporary shocks. To the extent that regional neighbours are specialized in goods or commodities with negatively correlated prices, there could also be scope for innovative regional stabilization mechanisms that the IFIs could also facilitate.

The above measures by themselves could contribute to mitigate consumption volatility by reducing income volatility. Yet, there may be other policy changes that could assist in this regard. One in particular seems to have potentially high payoffs in light of the analyzed evidence, and it is the recovery of the capacity to manage international capital flows. Since these are shown to follow pro-cyclically the fluctuations in terms of trade, and they have been often to be associated with consumption sprees facilitated by weakly regulated financial systems, national and international measures to throw some sand in the wheels of the international mobility of capitals might yield the double dividends mentioned before.

More generally, transitory and more long-term measures that contribute to smoothing consumption will have to be given high priority, in light of the sizeable dual benefits associated with them. It is interesting to note that IFIs have here a potentially key role to

play but also a conflict of interests.³¹ In fact, the analytical case could be made, based on the evidence of the country studies and the analysis above, that private consumption would be a more relevant target variable for macroeconomic (stabilization) policy than, say, GDP. This would be so due to the direct social consequences of volatile consumption, but also to the indirect impacts on the quality of institutions. The fixation with GDP as the key target variable could be blamed on the uncritical extrapolation of models used in advanced industrialized economies, where functional financial systems already make it possible for the private sector to smooth the temporal trajectory of consumption. For economies such as those studied here, however, the prevailing approach to macroeconomic stabilization would neglect a key complicating feature of their aggregate performance. But the implication of focusing on stabilizing consumption would be a more volatile trajectory for national *savings*. This puts IFIs, which are often a lead creditor and are largely responsive to creditor country interests, in the difficult situation of doing what could be best for its borrowing client and doing what is best for themselves. In other words, the peculiar political economy of developing country consumers and developed country lenders, in a world of imperfect global financial markets, may be one of the key factors making IFIs also ‘fearful of crises’ and inclined to follow reactive patterns of policy making.

Finally, the analysis in this paper also shows the potential value of a renovated approach to development assistance and ‘conditionality’. Rather than looking at these countries as middle-income giants that are too slow to learn but that will hopefully get their act together and ‘graduate’ soon, international development players could find ways to play a positive role in breaking the political economy traps in which they seem so often to fall. One way of doing this would be by becoming a positive force for policy change, with various forms of technical assistance and/or financing, during the boom periods of the business cycle. Those are the windows of opportunity for more systematic upgrading of the DFA, and ones that are too easy (and too costly) to miss under typical domestic political circumstances. Fortunately, locals and foreigners seem to be appreciating this: Nigeria’s recent attempts to introduce fiscal responsibility legislation, establish an oil

³¹ I thank José M. Fanelli for raising this point.

stabilization fund and improve financial supervision during relative good times, or the story of Brazil's own fiscal policy reforms in the late 1990s, show that the joint efforts of various actors can start to break the cycles of wrong timing, perverse political economy, and incomplete reforms. More of these efforts may help reduce the need for crisis assistance packages in the future.

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