INSTITUTO CULTURAL MINERVA

INSTITUTE OF BRAZILIAN BUSINESS AND PUBLIC MANAGEMENT ISSUES – IBI

THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

THE ROLE OF GOVERNMENT IN A MODERN NATIONAL ECONOMY – AN ECONOMIC APPROACH

By Marcelo Veiga de Castro Sparapani

Fall 2000

CONTENTS

SUMMARY

This paper discusses the role of the government forced to the deal with a new economy, focusing on the Central Banks issues.

The reference point will be an economy like the Brazilian one, with its aspects and needs.

The paper will start with the analysis on the monetary authority role, but not only. The role of the whole government system, including the judiciary and legislative, facing the changes connected with the new economy.

Also, it will consider the degree of management and interference to be played by the monetary authority for a developing country, such as Brazil, compared to the degree of a developed country, such as the United States of America.

The paper will comment on the globalized world and make a few historical considerations in order to support the statements and the conclusion.

I. Introduction: The Role of The Government

Those who live in countries are individuals whose history, in one way or another, made them stay and live together in a specific place or region. It's a natural trend for human beings to get together, be associated in groups in order to protect themselves and become powerful and capable enough to develop their lives.

Those associations generate markets and the necessity for rules to keep the group together and improve its condition. As the participants become specialized in one activity, because of its demand, they tend to create exchanges of goods or services that will have to be set by a kind of agreement, represented by gestures, written contracts or spoken language.

As the groups develop, changing into societies, the necessity for agreements or contracts rules becomes bigger. At this point, an institution is required to ratify those agreements and enforce the correct proceedings, guaranteeing the society development. And in order to keep the achievements of each individual and those of society, institutions are required to support them.

These institutions that come to be organized and guided by a leadership are considered a government. As long as the society becomes more complex, specialized and heterogeneous, government controls and procedures need to improve and develop. Optimizing these controls and procedures is more important than expanding or increasing them.

The role of the government is also essential to provide means whereby we can modify the rules, to mediate differences among us on the meaning of the rules. The government must enforce compliance with the rules on the part of those who would otherwise not play the game.

Absolute freedom is impossible, as Milton Friedman recognizes in his classic “Capitalism and Freedom”. The existence of a free market does not eliminate the need for a government. On the contrary, government is essential both as a form for determining the rules of the game, and as an umpire to interpret and enforce the rules decided on. As the Supreme Court of Justice once stated: “ my freedom to move my fist must be limited by the proximity of your chin”.

Adam Smith in his “Wealth of Nations” states that the main tasks for the governments are allocation of resources, redistribution of income, stabilization of economic activity and promotion of growth and employment.

The degree of governmental intervention will be given by the level of achievement in all these tasks and by the externalities. Of course, it’s sensible to say that undeveloped and developing countries need a higher degree of governmental interference than a developed country, considering both submitted to the same external conditions. Developing and undeveloped countries’ redistributing income programs tend to require more resources and governmental interference. These governments tend to spend more on public services, as education, health and bureaucracy, leading to a bigger taxation in order to support the so-called “welfare state”.

Eventually, the most common current view of the role of the government in a market economy is as follows: establishment of rules and institutions in order to enforce agreements and contracts, provide a legal and regulatory framework that diminishes market costs, thereby improving its efficiency and operations. In addition, the government must provide public goods and infrastructure, has an efficient policy to deal with externalities, promotes macroeconomic stabilization and an efficient income distribution in order to decrease the inequities and increase the standard of living for all.

Needless to say that the government must take into consideration the current global changes and trends in technologies and economic issues. They are likely to vary very quickly, sometimes with dramatic consequences.

II. The New “Globalized” World

As long as the telecommunications’ technologies have developed, especially in the last 30 years, and the flow of goods and people have sharply increased too, we become day by day a more “globalized” world. This has been a continuous process since the very early days of the modern history. Today, however, with the Internet boom, it has assumed an ultimate sense. The information velocity is almost instantaneous, as something relevant is happening somewhere in the world and people are being informed.

Concerning the economy, the flow of investments all over the world is "on-line", the information about market changes and political decisions, which affect investors actions, are worldwide spread in seconds. In one sense its good, because of the information availability for almost all, but it tends to generate faster chain reactions when any problem occurs in a given market. This might include a country, a common market, a regional stock exchange or even a bank. This kind of chain reaction, depending on the importance of the problem, can be so fast and wide spread that it becomes out of control, even for developed countries governments.

Another important thing that comes up with the globalization process is standardization, in all senses: goods, services, governmental systems, language, financial operations, etc.

Concerning the institutional issue, globalization tends to be a more dominant force than BI-lateral agreements between countries or companies. Also the way political and economical issues are judicially treated becomes more equal. It becomes, in one sense, a loss of sovereignty for each country, as sometimes internal costumes and cultural beliefs on some issues must be taken away for a moment, in order to not hinder the country position any further.

About the production issue, it's been largely affected by globalization, as companies have become more international in order to be more competitive. Today the flow of product parts is huge as the companies seek for comparative advantages wherever they are. And it's not only for the parts and raw material that international companies are looking for advantages; even manpower is a globalized factor today. These companies carry on studies of manpower availability all over the world in order to get the most adequate one. They cross information about their abilities, country's political and geographical situation, wages applicable, foreseen expectations, etc. Then, as a result, and also as a requirement, the production all over the world for a given item is becoming more and more standardized, even among competitors. This is because the improvements and advantages taken by one will be soon incorporated by the competitor's product. It's important to mention that not only the international companies do it by themselves, but also together sometimes. It's more effective, by international agreements that in some cases are leading to a very up to date issue, which is the merging of the big ones. Some see it, as an unstoppable trend that will lead to few big worldwide conglomerates. Some don't. All of this competition, for the best production comparative advantage abroad has been "sponsored" in recent decades by the decrease of commercial barriers among countries.

Financially speaking, the globalization process also brings some "loss" of sovereignty for one country, when some fundamental issues as wages, exchange rate, fiscal policy in terms of products subsidy and interest rates are no longer expected to be set by the local government desire only. The increase of capital flows raised dramatically in the last decade, especially for developing and undeveloped countries. The relevance of the financial markets increased as a GDP share for the main OECD countries. Between World War II and 1990, it has doubled, according to the BIS Annual Bulletin. Financial instruments, such as derivatives, combined with a dramatic decrease of international debtors-creditors transaction costs, levered the amounts involved hugely (figures of mid 90s for international derivatives trade amount over US$ 20 trillion). Another trend observed lately is the diminishing restriction on financial intermediary activities due to a ferocious competition and countries' deregulation actions, with few exceptions.

The financial market suffered deep changes in its structure as banks are no longer the main actors, other institutions like financial intermediaries and investments funds companies are taking over a relevant amount from investors. These institutions are doing intermediate transferring-risk operations. Capital inflows affect the financial system, which is doing the intermediate operations.

The capital inflows make the fiscal debt increase as a result of sterilization policy that sells high-yielding domestic bonds, and buys foreign exchange earning lower interests. In Latin American countries, estimates of such costs range from 0.25 to 0.5 percent of GDP a year. Also, the financial system is likely to become more vulnerable because of a rise in lending that may exacerbate the maturity mismatch between bank assets and liabilities, and reduce loan quality. The increases in a bank credit were a generalized outcome of capital inflows, and increase of asset prices as well. It tends to make the financial sector more vulnerable because households' debts and consumption rise as appreciated assets are used to guarantee new loans. Poorly managed and supervised banks might finance consumption booms and speculative activities, such as a boom in construction and real estate. Thus, resources will be misallocated and financial distress will be a likely outcome once asset prices decline. This fall will be accompanied by higher interest rates leading over indebted agents to default on their debts, and the reduced value of the guarantees won't be enough to cover the banks' losses. According to the World Bank (1997), countries with the highest increase in bank lending were not only the ones that later experienced a banking crisis, but also were usually the ones in which macroeconomic vulnerability was higher, measured by increases in the current account deficit, real exchange rate appreciation, excessive consumption and low-investment.

It's important to say that not only macroeconomic factors are relevant in capital flows' levels but so are the microeconomic ones: asymmetric information due to a vast menu of available investments; inadequate supervision and regulation of financial institutions; "shallow markets" that allow fast contagion in a crisis; price and wages rigidities that can lead to distortions in a short run after a exchange rate appreciation.

Generally the policy makers of one country are not appropriately concerned about the policy response to large capital inflows and its reversals. But they should be, as the integration among countries become stronger the volatility and contagion associated with private capital are more likely to increase.

The volatility can be associated directly with these factors: interest rates, stock market investments and contagion effects. Changes in interest rates can have large impacts on the macroeconomic performance and creditworthiness of developing countries. Moreover, if investments in emerging markets are used only to increase portfolio returns when investments in industrial countries are not satisfactory, then the investment will be very sensitive to changes in industrial countries' interest rates. This sensitivity, however, has been observed more clearly for porfolio investments than for foreign direct investments.

The contagion process can be stated up due to the following factors that may occur one at a time, but are more likely to come together sometimes. The trade arrangements and exchange rates pressures contribute to volatility and contagion as when a depreciation happens in one country, the others which trade with that country as competitors in third markets are likely to suffer in terms of competitiveness and output. This, in turn, makes their currencies more susceptible to speculative attacks.

The "wake up call" phenomenon happens when a collapse of one country's currency alters the investors perception about other countries' fundamentals. If investors find the same weakness factors in these other countries their ratings are reduced and the crisis spreads. It can be called the "herding" behavior. As other types of human behavior, it's largely associated to psychology. This behavior, observed largely among institutional investors, is attributed to asymmetric information and induces common outcomes in countries with very heterogeneous fundamentals. Fund managers tend to follow colleagues' decisions to show clients that they know what's going on. There always will be an excuse if this decision was not the most appropriate, if the fund does not profit it's more likely that the manager is considered unlucky than unskilled. And if the fund does not achieve good performance, probably with the "herding" behavior it will be considered average, at worst.

The “large neighbor” effect in Latin America is when smaller countries are systematically influenced by the capital account developments in their large neighbors. Another factor of contagion is the financial links among countries. For example, what happened in Korea recently. The patterns of financial holdings can lead to shocks being propagated into other countries, regardless of their fundamentals. Korean banks accumulated significant amounts of high yielding Brazilian and Russian government debts. Then, when Korean banks had liquidity problems they began to sell Brazilian and Russian assets, leading to falls in asset prices in those countries, and substantial sales of Russian debt by Brazilian investors.

Eventually, liquidity management practices of open-end mutual funds are a fifth channel of contagion. Leveraged investors facing margin calls have to sell their asset holdings, and because of information asymmetries, the assets might be sold at low prices. Another case is an open-end portfolio manager who needs to raise liquidity in anticipation of future redemption. The best strategy would be selling assets in the portfolio that have not collapsed yet. However, because of this behavior, other asset prices fall and the original disturbance spreads across markets.

III- The Need for Rules

As it was described previously, the forms that the government can intervene in economy require specific programs and these programs require a legal mandate.

In democracies with market economies, the mandate for intervention in the economy is specified and given first by the constitution and then, in a secondary level, by laws and regulations that give a specific content to the more generalist principles enunciated by the constitution. The laws and regulations state the rules of the game, for individuals and enterprises on one side, and for the governmental institutions on the other side. As previously commented, most relevant is the degree that the government intends to reach with these rules.

The constitutions often don't express the principles very specifically, although they might be clear. The constitution must be a living document that guides general actions, but it can not be the one that addresses specific situations or that anticipates activities or situations that don't exist at the time the constitution is written.

The American constitution is a good example that rarely requires amendments, besides the role of the Supreme Court in interpreting the American Constitution is unchallenged. It became a cultural guideline for the North American society, not needing to be consulted every time to be remembered or understood.

The current Brazilian Constitution, from 1988, is an example that gives very restrictive constitutional limits, sometimes going deeply specific, sometimes too vaguely. In recent years, this document has prevented the Brazilian government from making important and badly needed reforms in fiscal federalism and in the national pension system. Some articles, even going deeply in some issues, allowed loopholes for not well intended actions that normally hinder the economic development and the government system work. These loopholes backed up the judiciary with millions of processes that take a long time to be solved.

Normally the constitutions tend to reflect the worries and the political forces of the time they were written. In any case, they cannot be complex and confused or it's very likely they not only won't fulfill the current people's aspirations, but also create legal problems that will aggravate the general situation.

Some economists think that the constitutions, concerning the economic and fiscal policy, should state not what the government must do, but what it must not do. It would be desirable to stress tax limitations, public spending levels or fiscal deficits in favor of the free market operation. The Maastricht Stability and Growth Pact might be seen as an example of these limitations in a constitution.

The laws, of course, must be consistent with the principles set by the constitution. It's almost possible to generalize that the quality of the public sector is inversely proportional to the number of laws. This demonstrates that they are clearly written, not subject to conflicting interpretation and not in conflict among themselves.

The opposite is obvious, too many laws, conflicting and unclear lead to a messy situation. At each time that a new law is enacted, all the existing laws should be scrutinized and if necessary, revised to make sure that all the elements of these laws are consistent with the new law. This of course, doesn't happen, and where there are more laws that are unclear, the results are even worse. This tends to generate what is called "legal inconsistency", often found in the national and sub-national government relationships or pension and health programs against annual budget laws.

The regulations come often together with the laws, and can be classified in three groups: economic regulations, safety regulations and information regulations. Regulations explain procedures or elaborate on the content of the laws or simply impose specific behavior on individuals and companies. Regulations issued by an executive authority or by a regulatory agency can be very complex, not easily accessible by the public and may overlap with another regulation. Regulation is perhaps the most pervasive form of state intervention in economic activity, according to a recent OECD report. As the laws, the regulations are subject to the same form of misleading, that tend to lead to confusion or even abuse by the bureaucrats who are formulating them.

Many countries are now struggling to create needed regulations for the financial and banking sectors, for the use of Internet information, for genetic research, drug research and other important areas. The need for these regulations became dramatic as the new technologies, such as Internet and genetic engineering came out. The financial regulation is also a critical point, especially for undeveloped and developing countries that can be not exposed to the dark side of the globalization process. The globalization brought new investment possibilities and the new technologies allowed them to spread out very quickly and cheaply, so now the international financial world is linked and pulverized all over in a manner almost irreversible. Because of this, the governmental regulations must keep up with the development of the international financial market, in a quality sense and in velocity.

Taking in consideration the practical real world, in addition to the formal constitutional rules, laws and regulations, the quality of the public sector is affected by informal norms or arrangements. This influences the economic behavior of individuals and the behavior of the public sector. These informal norms may be based on religious, social, or political considerations. Being of an informal nature and being based on cultural characteristics, they are difficult to change. Still the even application of the law to all aspects of the public sector behavior will be a target in pursuing of the state quality.

IV. The Need for State Development

The government, the public sectors through its institutions, agencies and personnel can only proceed their tasks according to the constitution, the laws and the regulations. These legal apparatus are the tools available for the state to operate.

Civil servants are not entitled to do things according to their wishes. They have a limited choice for their decisions, which can never go against the law, regulations, budgets, normative instructions, etc. Of course, the higher the level of the civil servant there will be more choices of decisions and freedom to act as its position will be more empowered; but at the end, regardless of the position there will always be the constitution.

Political arrangements also play a relevant role in the game. Arrangements like fiscal federalism and fiscal decentralization, proportional and non-proportional representation in parliaments, the frequency of elections, the choice of presidential versus non-presidential types of governments, the role of the ministry of finance as super ministry, the rules that apply to the budgetary process. For example: whether it starts with macroeconomic constraint which reflects a collective view on priorities or whether it allows pressures for spending to be determined through the political influence of each minister, whether the Central Bank is more independent or not. All of that can have a significant impact on fiscal and macroeconomic outcomes.

Political and procedural rules are more likely to affect policies than the quality of the public sector, or of public institutions. These are the institutions that confront the citizens and that implement the policies. But, of course, by changing the incentives under which policy makers and institutions operate, the political and procedural rules may affect the behavior and, thus the quality of the institutions and vice-versa.

The rules are just a set of instructions, they are not yet the policies. Until the game is played, these rules remain just pieces of papers, and the game is played by the institutions responsible for carrying out these instructions. The way it will be carried out, faithfully or effectively is another variant. The sum of the institutions' performances will determine the quality of the public sector. It is observed in some countries the absence of some essential institutions and the poor performance of the existing ones.

In many countries, there are no institutions responsible for enforcing competition or for forcing full disclosure on the part of financial institutions. As a consequence, the market will be weakened and deviated from its real potential, as there will be a lack of essential information.

The performance of public institutions depends also on the following factors: tradition and reputation, the resources available and the way they are used, the clarity of their mandate, their organization, the incentives provided, the quality of the personnel and leadership, and the freedom and willingness they have over reengineering matters.

In order to improve the public sector, a large number of steps must be taken, deep ones. Many individuals form the public sector, thus its culture and performance will reflect the society it serves. The weaknesses observed in the country's society will be present in the public sector. Then the steps needed for the improvement of the public sector are the same needed for the society, obviously apart of few considerations. The public sector needs constant training in order to prepared to deal with new technologies and demands brought together.

Concerning the economical area staff of the government, they must have a high level of expertise. In the ministries, Central Bank and agencies, there must be experts in specific issues capable to handle the challenges of the globalized economy, especially if they are in undeveloped and developing countries, more likely to be heavily submitted to turmoil situations and international crises.

The judiciary and legislative systems play a fundamental role on the state development. The legislative branch, in a democratic regime, is responsible to update the guidelines for the society. As long as the world is being globalized, new issues are coming up, new economic and political conditions appear, new social claims are demanded by the society and new international pressures demand changes inside the countries' borders.

Politicians in the congresses and senates around the world must be prepared and sensitive to foresee these demands. They will be demanded by society and international community to enact laws and even change their constitutions to avoid hindering their countries' insertion in the globalized world.

There will be no time for recovering, the more agility the deputies and senators have, the more useful and profitable will be the laws. The world today doesn't stop to wait for those who are hesitant. If the progress wave is on, the lucky ones are those who are enjoying. History has showed that the positive progress comes and goes in cycles, and what we are currently observing is a growth cycle in most of the world. This is one extra reason for the politicians around the globe to be paying the appropriated attention to current demands and consequences of the globalization process.

Also, the quality of a country's laws is critical, for the international community to determine the reliability on this country economy. The laws of one country must give to the international investors, banks and agencies, an aura of reliability and seriousness enough to make them believe in this country's efforts to succeed, or at least believe that they are protected from dishonesty.

As essential as the previous statement, the laws must allow the progress and growth of its country, not imposing complicated patterns for the society. On the contrary, they must encourage individuals and companies to undertake their projects. The laws cannot be absent or so weak that they don't protect the society in its effort for the economic and social development. Laws must help the societies.

The role of the judiciary branch is critical; it will be useless for a country to have an advanced and good legislation if the judiciary system is not effective. The judiciary system must be able and agile in order to implement the legislation according to the society's demands. There must be a national and international sentiment that the country judiciary system is reliable, in order to encourage those who will play the game to follow the rules. Agility is also critical for the judiciary, as a good decision might be useless and even unfair when the demand becomes outmoded or no longer exists.

There must be a synergy among the government institutions. Like different elements of an ecological system, public institutions work together and support one another so that it may not be possible to have a first-class tax administration in an environment where other institutions, such as the treasury or important ministries or the judiciary, or even the post office, do not work well. Often the same weakness affect different institutions. This implies that attempting to improve just one institution, when the others need equal improvement, is not likely to generate the desired results in the long run.

The inter-institutional externalities (either positive or negative) are very important and must be recognized and dealt with in any attempt at improving the quality of the public sector. A holistic approach that addresses problems in different institutions at the same time is likely to be necessary. However, such an approach, which is inevitably difficult to follow, must be guided by a clear strategy and by the proper sequencing of the changes required and made. If this approach requires more time to be implemented than the political horizon of the government that introduces it, it is less likely that it will be fully implemented. That’s why the quality of the public sector tends to change slowly over time, and requires a strong and almost unanimous demand from society in order to force the governments to do it, regardless of different mandates.

V. The Role of the Central Bank in Brazil

The need for economic rules is fundamental. The government must provide a good allocation policy for resources, redistribute income and have instruments to manage level of economic activity. There is no other area better accepted to be a government issue and duty, than the monetary system. The monetary system must not be defined and regulated by the market, due to the risk of distortion of the rules and the arbitration in self-interest.

The Brazilian Central Bank was established in 1964, by the federal law 4,595. It was created in order to be the society's agent in the promotion of stability and maintain Brazilian currency's power purchase, by the permanent pursuing of the following targets: secure the appropriate economy marketability; maintain in appropriate levels the foreign reserves; stimulate the saving according to the necessity of the country's investments; look after the stability and promote the permanent National Financial System (SFN) improvement.

The 1988 Constitution gave the Central Bank the exclusive task of issuing the Brazilian currency. The current legislation and regulations established the functions as follows: formulation, execution and attendance of the monetary policy; credit operations control; formulation, execution and attendance of the exchange policy and financial relations with the foreign countries; organize, discipline and supervise the SFN and the financial market; issue the national currency and make the money supply.

Today, Central Banks all over the world are concerned with the digital communication and the globalization that have brought a very linked and dependent economical mechanism.

The markets today have complex and tied up operations that, due to turbulence anywhere, a regional market can face a huge capital flow leading to an internal crisis. Thus, the control or monitoring, or the inability to control or monitor the capital flows becomes a critical issue for Central Banks, especially in undeveloped and developing countries, like Brazil, where the effects of these flows can be devastating for the economy. The issue of control or monitoring is one of, how, how much and when?

Countries that have managed to overcome overheating and the adverse effects of the financial sector of capital inflows have relied on more than a single policy measure. After all, the appropriate combination of policy options depends on a variety of factors, such as the causes behind the inflows (whether they are temporary or permanent), the availability and flexibility of different instruments, the nature of domestic financial markets and the climate of the macroeconomic policies of the recipient country.

In an exchange rate regime that may be utterly flexible, monetary policy avoids aggregate demand pressures by sterilizing the monetary expansion caused by the accumulation of international reserves. The larger the accumulation reserves, the more thoroughly the authority will avoid nominal exchange rate appreciation. In turn, this will imply a stronger sterilization policy if the increase in monetary aggregates is to be limited.

There are three types of sterilization policies: open market operations, increases in reserve requirements and management of public sector deposits.

Sterilization via open-market operations usually takes place through the Central Bank's sale of high yield domestic assets, either government or Central Bank securities, for low yielding reserves. This type of sterilization has two main advantages. First it reduces the monetary credit expansion generated by the purchase of foreign currency without increasing the burden on the banking system of higher reserve requirements. Second, in limiting the role of the banking system by playing the intermediate action in the flows, reduces the banks' vulnerability to sudden reversal of flow. However, open-market operations tend to increase domestic interest rates. This happens if domestic assets issued in the sterilization operation are imperfect substitutes for other domestic currency assets that investors want to hold, or if the demand for the money increases as a result of higher growth or lower inflation. Consequently, this type of sterilization has three disadvantages. One, it induces further capital flows through the increase in domestic interest rates; two, it alters the composition of capital flows, reducing the share of foreign direct investments and increasing the share of short-term and portfolio flows; three, it raises fiscal costs by widening the domestic and foreign interest rate spread.

An increase in reserve requirements reduces the money multiplier. Thus, it also offsets the monetary expansion associated with the Central Bank intervention in the foreign exchange market. This policy has the advantage that it decreases the capacity of the banks to lend without the fiscal costs caused by open-market operations. But increasing reserve requirements also have several shortcomings. It reverses the trend of financial liberalization in countries like Brasil, hampering efficient allocation of credit. If taken for a long time, high reserve requirements promote disintermediation. As a consequence, funds are shifted to the non-bank financial sector and the desired effect of avoiding monetary expansion is not achieved. Eventually, similar to open-market operations, this type of sterilization policy stimulates further capital inflows. In fact, reserve requirements induce borrowing from abroad because they are a tax to the financial system that is transferred, at least in part, to the bank's clients through an increase in loan rates. However, the policy is better understood as a form of capital control since it aims at discouraging a particular class of financial liabilities, rather than restraining overall lending.

The Central Bank can also manage the public sector deposits. This type of sterilization shifts deposits of the public sector or pension funds from the banking system to the Central Bank. If government deposits are counted as part of the money stock, the policy is equivalent to a reserve requirement of 100 percent on this kind of deposit. If they are not counted as part of the money stock, the policy is similar to an open-market operation, with the difference that the Central Bank does not have to pay interest on its deposits as it would on its sterilization bonds, thus avoiding fiscal implications. Contrary to reserve requirements, management of the public sector deposits has the advantage of not taxing the financial sector. Nevertheless, the policy has its drawbacks. In particular shifting deposits as a tool for further sterilization is limited by the availability of eligible funds. In addition, large and unpredictable changes in bank deposits make it difficult for banks to manage their cash positions.

A trend and a policy, observed in Brazil after the beginning of the 1999 crisis, is the nominal exchange rate flexibility. If it is desired to avoid the expansion of monetary aggregates associated with the capital inflows, the monetary authority can reduce international reserve accumulation by allowing the nominal exchange rate to appreciate. This counter cyclical policy has several virtues. First, it insulates the money supply from the inflows. The greater the exchange rate flexibility, the larger the insulation of the money supply and the autonomy of monetary policy. This advantage is particularly desirable when the flows are perceived to be reversible and supervision of the financial system is poor. Second, with the exchange rate flexibility the appreciation of the real exchange rate is likely to occur through a nominal appreciation rather than through higher inflation. Given the links between the nominal exchange rate and inflation, the latter is likely being lower when the former is allowed to appreciate. Third, flexibility in the nominal exchange rate introduces uncertainty, which can discourage speculative short-term capital inflows.

However, if the nominal exchange rate is allowed to appreciate, the profitability of the traded goods sector will suffer. Strategic sectors, such as nontraditional exports, will be damaged if capital flows are persistent and real exchange rate appreciation appears to be permanent. Still, even if capital flows are temporary, the real exchange rate will be volatile. This might have negative effects on the tradable goods sectors through different channels. If the real exchange rate appreciation is sufficiently large, it might induce variations on the trade balance, altering the steady state real exchange rate. Also, the tradable goods sector will be negatively affected if financial sectors are insufficiently developed and, thus do not provide enough instruments to hedge against real exchange rate volatility.

From the Brazilian example it was learned, painfully, that using the exchange rate as an anchor or as an instrument of short-run stabilization could lead to persistent and large misalignments, threatening the sustainability of the regime and stimulating speculative attacks.

Fiscal policy is another instrument which is used to combat distortions created by the capital flows, decreasing the public expenditures which lowers the aggregate demand and reduces the inflationary pressures of the capital inflows. This policy avoids the costs normally associated with other types of sterilization. Also, fiscal restraint is a substitute for the exchange rate flexibility as a stabilizing instrument. A cut in public expenditure is likely to limit the appreciation of the real exchange rate, since non-tradable goods often represent a significant share of public expenditures. Reducing the pressures on the real exchange rates has several benefits. One, is to induce smaller account deficits. In addition, it favors investment over consumption since the former is more likely to be affected by the traded goods than the latter. Then, the result is likely to induce a faster growth in the economy.

However, it has to be considered that fiscal policies are not flexible enough to respond to fluctuations in capital movements, as it is a decision that is not made solely by the Central Bank. Normally there must be a general acceptance by additional top institutions in the government.

Regulation and banking supervision are supporting devices for macroeconomic policies.

Countries, which experienced financial crisis, were facing current account deficits, real exchange rate appreciation and under-investment. Correcting these figures might be insufficient to guarantee a reliable financial sector. Banking regulation and supervision become critical elements if there are failures in internal governance and market discipline. They reinforce the operating environment, strengthen internal governance and improve market discipline. The operating environment is reinforced with well-designed controls limiting entry into the banking industry and the scope of banking. Internal governance is strengthened when regulations promote fit and proper owners and managers, require owners to put their own capital at risk, and implement appropriate loan valuation and classification practices and supporting accounting standards.

Market discipline is improved when regulation ensures that market participants have as much information as possible to judge the reliability of banks, and that sanctions imposed by the market are taken. A key problem with market regulation and supervision is that financial institutions can easily avoid them. In most developing countries, prudential regulation can be evaded through on balance sheets operations that artificially increase the banks' regulatory capital position. Moreover, the surge of huge offshore derivative markets has increased and encouraged the methods of evasion. To reduce the possibility of avoiding regulations requires rigorous, comprehensive surveillance across the corporate structure of the financial system. Although there are limitations of bank supervising and regulation, these implementations are very important to reduce the vulnerability of the financial sector during capital flows associated with lending booms and unsustainable surges in assets prices, and its reversals. An effective financial market regulation is fundamental in order to protect the country against temporary distortions that can lead the market to serious and extended crises.

Money has no flag. It is invested in the most attractive place and situation available, with little loyalty and concern for one particular market if the money is being removed. Thus, it seems obvious that regulations that help to strengthen the country's bank system are very desirable, especially for critical situations. A sound bank system can be measured by the high capitalization rate, the ratio of capital stock relative to the stock of bank assets. The increase of the capitalization rate reduces the likelihood that banks could default on their borrowing if investments fail to reduce the vulnerability caused by capital flows.

Also, it would be highly recommended to have a rise in provisions for future losses (as a share of the stock of total loans), a high liquidity of bank assets and the shorter maturity of liabilities relative to assets.

Capital control is a possible response from the Central Bank whenever a country's economy is unstable because of large capital movements. Capital control can improve welfare in an economy suffering from distortions. The effectiveness of capital controls is defended by two arguments. First, capital controls tend to maintain the relation between domestic and external interest rates. Thus, helping the authorities to gain control over domestic monetary conditions when the exchange rate is fixed or managed. Second, countries with capital controls typically have higher rates of inflation, higher revenue from inflation, and lower real interest rates than countries without controls. In such countries, capital controls are seen as tools to maintain government revenues associated with financial repression and to reduce government debt service costs. Still, if they are used to support inconsistent monetary and exchange rate policies, they become ineffective in preventing the balance of payment crises.

In Brazil, the exchange rate in the last decade has changed from a fixed to an almost flexible one, with the so-called "dirty-floating", where the Central Bank can still intervene in extreme cases. What is extreme? This is the critical point in order to define "flexible". The capital flow control is done by the Brazilian Central Bank in two of its departments: FIRCE (Foreign Capital Registration and Supervising Department) and the DECAM (Exchange Department). The FIRCE takes care of the long run operations, above 360 days terms and are submitted to registration, according the 4,131/62 law. And DECAM takes care of the short run operations, under 360 days terms.

A third department is the DEPIN, International Reserves Operations Department, which takes care of the exchange policy and intervenes in the exchange markets, whenever it is necessary. This department did not have much to do in the past, as the reserves were so small. In addition, there were so many prohibitions that there was not a market to intervene and the exchange rate was an administrative decision.

In Brazil we use the same legislation which was written 30 years ago. But, the vague language that was used allows for a much more liberal interpretation nowadays. There has been a tentative reformulation of this legislation due to the changes in the international scenario and the monetary alterations induced by the “Real Plan”. However, the Central Bank has to work with a vague, old legislation that allows different interpretations and gives freedom to the monetary authority, to the CMN (National Monetary Council) and the government board to intervene more or less according to their political orientations.

In the last years, the more liberal approach to the exchange issues, done by the Central Bank, was almost totally infra legal. The “tourism-dollar” market growth, its evolution to the “floating exchange rates market”, the new definition for the accounts in reais belonging to non-residents, the creation of the inter-banking exchange rate market and the various uses for the RDE (Electronic Declaratory System), have been done with infra legal regulations as “circulares” or at best, CMN resolutions.

The last Brazilian Central Bank administration tried to transform the role of the FIRCE and DECAM departments through administrative means. The FIRCE is now responsible for the republic bonds issued in foreign countries and performs the Foreign Capital census. In the future, these functions are expected to change, like dealing with rating agencies and investors together with other departments. Also, the census is expected to be a permanent effort of collecting information, not only about the exchange market, but also about companies with foreign capital investments.

In the DECAM, some duties were given to other departments, and what is most desirable is the integration with the DECIF (Financial and Exchange Illicit Control Department) associated with the Central Bank presidency and the COAF (Financial Activities Control Council). Concerning the focuses of DECAM activity, it is no longer desirable to supervise the operations' exchange regulations, but to do intelligence work on the capital flows in order to combat illicit money flow.

It is a task for the Central Bank to give up the outmoded way to supervise the international flow of capital, imposing restrictions, hindering the financial operations and delaying, because of the bureaucracy, the registration for foreign direct investment. Training must be given to the Bank staff in order to change this kind of approach into intelligence work, capable of providing the police institutions with information about the illicit flow of money. Legal flow cannot be hindered because of the illicit flow supervising, at risk of being transformed into a capital flow control instrument.

In face of large capital inflows and the trend toward financial liberalization, capital controls have recently served a different purpose than in the past. Rather than to avoid nominal devaluation of the exchange rate, they have been implemented to reduce nominal and real appreciation of the exchange rate. In the 1990s capital controls aimed at diminishing pressures on aggregate demand, whereas in the past the purpose was to avoid low medium-term growth caused by declines in investment and consumption after capital outflow. Although capital flows in either direction complicate the monetary policy, capital controls seek to reduce monetary and credit expansions during inflow periods. On the contrary, during outflows times the Central Bank should try to avoid rising interest rates that can put more pressure on the financial system and a high cost on government debts. In the 1990s the adoption of capital controls could be seen as a precautionary measure. They reduce the destabilizing effects associated with the inflows and, by doing so avoid the traumatic effects associated with outflows.

The capital flow controls, besides the bureaucracy effect, can be done in two ways. One is quantitative controls to regulate the volume of capital flows. In this decade, quantitative limits on inflows have taken different forms of in a wide variety of countries and with varying degrees of success. For example, in 1992 Mexico limited foreign currency liabilities of commercial banks to 10 percent of their total loan portfolio. However, this measure did not succeed in reducing the size of the inflows because the banks' total loan portfolios were expanding rapidly and the initial share of loans in foreign currency was below the 10 percent limit. Another example of a country introducing quantitative limits on inflows is Malaysia. In face of speculative flows associated with speculative short-term bank deposits, Malaysia imposed six measures to restrict inflows, announced to be temporary. Among them, one prohibited domestic residents from selling short-term money market instruments to foreigners. Contrary to the Mexican experience, this measure, combined with the abandonment of sterilization, succeed in reducing domestic interest rates and short-term inflows. Still, this police could have jeopardized the competitiveness and development of the financial sector if maintained for a long time. Finally, other types of quantitative controls have taken the form of prudential limits on, or even prohibition of, non-trade-related swap activities, off-shore borrowing, and banks' net open market foreign exchange position.

The second is the application of taxes in transactions or taxes-like measures, for instance a non-interest bearing reserve requirement on foreign borrowing. These restrictions are more likely to affect the short-term operations, like the portfolio investments, than the long-term ones.

These tax-likes measures were adopted by the Brazilian Central Bank in 1993, but after the Mexico crisis, in 1995, it backed out. Also, when a country like Brazil, that needs investment, even short-term investments in the stock markets, start to impose taxes and restrictions, the investors become afraid and reluctant to bring their money into the country. The consequence is that the investor finds somewhere safer to invest. This policy has several advantages. It increases the autonomy of domestic monetary policy, reduces the likelihood of speculative attacks on fixed exchange rate regimes, and encourages long-term investment rather than short term speculative opportunities. But there are disadvantages too. First, too be effective it would need to be adopted worldwide, otherwise, the taxed activities would shift to untaxed countries. Second, if banks do not have large position taking, it will not be effective to penalize short-term cross-border bank loans. Third, taxation of foreign exchange transactions becomes difficult given the increasing possibility of creating synthetic positions. Fourth, tax would reduce trading and could lead to less liquid markets, thus contributing to greater volatility in international capital markets.

Non-remunerated reserve requirements to be deposited at the Central Bank on liabilities in foreign currency associated with direct borrowing by firms are an example of tax-like measures used to regulate the volume of capital flows. This type of capital control seems to promote long-term capital inflows and to discourage short-term flows. This policy is based on the popular perception that long-term flows are more guided by medium-term fundamentals and are less sensitive than short-term flows to cyclical fluctuations in domestic or international interest rates. In addition, the policy discourages short-term inflows because they are associated with rapid expansion in short-maturity bank deposits. Consequently, if the banking sector is inefficient or poorly supervised, the authorities have an incentive to reduce the role played by banks as intermediates.

Although, in the 1990s capital controls had little effect on consumption, the current account, and the real exchange rate, they were capable of either reducing the overall volume of inflows, altering their maturity profile, or both. This suggests that the lack of effectiveness of capital controls is not symmetric and that they may be more effective in controlling inflows than stopping outflows.

That’s why these policies are less effective than a good long-term policy investment and a sound financial system, that are not so dependant on the short-term capital, diminishing its effects in turbulent situations.

If the purpose of capital controls is to reduce the volume of net inflows, removing outflows restrictions could attain the same result. Nevertheless, this policy might attract additional inflows. In particular, if controls on outflows happen to be effective, they would make inflows irreversible, leading creditors to refrain form lending if they are uncertain about the return on loans to domestic agents. Consequently, the removal of controls on outflows would eliminate this irreversibility, stimulating further inflows. If capital controls are used to maintain government revenues associated with financial repression, their removal could also increase capital inflows because they could be interpreted as a signal that this type of taxation will not be used in the future. This argument also suggests that encouraging gross outflows should be one of the last steps in economic liberalization and requires fiscal stability. As with trade liberalization, encouraging gross outflows is a structural policy that should be designed so as to be consistent with long-term objectives rather than as a counter-cyclical response.

IV. Conclusion

The role of government is essential for every country. The developed countries, so-called “first world ones”, reached this position because of an almost infinite number of historical and geographical factors. But apart from these historical and geographical factors, sometimes very diverse, one thing they have in common: the good role played by their governments has crystallized these factors and led their societies to a better standard of living.

The Internet is the base of the new economy, making a democratic information distribution, due to its low cost and speed. Information will play a critical role in the new economy, reducing market imperfections, making it even fairer. This democratic information helps to abolish barriers, stimulate competition, diminishing the costs and most important increase efficiency. In the countries citizens increase their power as consumers, as services render and improve citizenship. The financial markets will also benefit, as the costs decrease, the borders no longer exist and the intermediation system becomes more agile and intense.

It will lead to the clear perception that all countries’ markets are exposed to the globalized economy, but not equally. Those, which have a sounder financial market and economical policies, are less exposed. That’s why a country such as Brasil has to pursue the original Central Bank functions in order to reach the same level as solid ones, like the USA. Thus, as Brazil has adjustments to be made in order to get there, interventions will be required more often than in a country in which the situation is more comfortable. The poorer and weaker the situation and the financial market, the deeper intervention in economy that will be required, in order to create an internal environment adequate to the operation of free market laws.

There are no recipes good enough to ensure the best use and the most sustained inflow of capital. The successful policies already known vary across countries as different conditions, external and internal, were present in each country. These internal conditions might be the recipient country anti-inflationary record, the openness of the economy to foreign trade, the public finance situation, the size and liquidity of the domestic bond market, the health of domestic banks, the flexibility of fiscal policy, and the most relevant one: the quality of the regulatory and supervisory framework over the financial sector. Thus, the government must use a combination of various policies such as fiscal, monetary and exchange, as they will interact anyway. And if they are not properly coordinated the interaction effect can lead to an ineffective result or worse.

The judiciary and legislative systems must be well organized, effective and focused on these new economy demands. These institutions are critical for the country's reliability, which definitely encourages the foreign investors. It is useless to have the best monetary, exchange and fiscal policies if the legislative and judiciary systems are outmoded, ineffective, weak and not committed to the country's development in this new era. If the legislative branch does not work properly, the laws tend to be insufficient and ineffective to discipline the country's legal framework where the financial market is located. On the other hand, even with a good legal framework, it's essential to have an engaged and active judiciary system to help to enforce the law. Of course, all the governmental institutions are expected to be well synchronized and active, creating a positive synergy where the legislative and judiciary systems will provide the support for a suitable economic policy to succeed. The country's legal and economic framework will be critical in order to influence the investor's choice, where to invest in expansion periods and where to get out first from during a crisis.

A free market is an effective way to improve the standard of living for a country's population, as long as all the population is participating in this market.

Undeveloped and developing countries have a fraction of the population excluded from the market, because of their extreme poor situation. Those are likely to be even more excluded in a globalized "hi-tech" world. Undeveloped and developing countries' governments cannot wait for the multilateral institutions to help them on this issue. The "excluded population" requires an attention from those who are nearby, very well informed and deeply concerned about them.

Normally, the recipes from these multilateral institutions are very general. These recipes are useful only if the local government had already taken a first step. These multilateral institutions are more like banks instead of governmental agencies, and we know that banks are not the most appropriate entities in order to provide basic assistance for the poorest population.

In order to avoid an increase in income inequity, the government must intervene by pushing this fraction of the population into the market. How? By providing them with fair education and basic needs in order to allow for their own development.

It may be very difficult to establish an objective poverty line definition, in which case the government's decisions are likely to be influenced by the political orientation of the individuals who constitute the current regime and by the prevailing social issues of the time. But this task has to be done, despite political orientation, and despite the current state of the budget.

There are problems that can not be left behind, because they run the risk of always becoming bigger and eventually unsolvable.

References

1. Calvo, S., and Reinhart, 1996, Capital Flows to Latin America: Is There Evidence of Contagion Effects?" in Private Capital Flows to Emerging Markets, Institute of International Economics.
2. Cardoso, Eliana, and Ilan Goldfajn, 1997, "Capital Flows to Brazil: The Endogeneity of Capital Controls", IMF Working Paper.
3. Detragiache, Enrica, 1999, "Bank Fragility and International Capital Mobility", IMF Working Paper.
4. Fernandez-Arias, E., and P. Montiel, 1996, "The Surge in Capital Inflows to Developing Countries: An Analytical Overview", The World Bank Review.
5. Gomez, Jose Maria, 2000, "Politica e Democracia em Tempos de Globalizacao", Editora Vozes.
6. Kaminsky, Graciela L., Reinhart, Carmen M., and Goldstein, Morris, 2000, "Assessing Financial Vulnerability", Institute for International Economics.
7. Kaminsky, G., and Reinhart, C., 1998, "On Crises, Contagion and Confusion", paper for The Duke University Conference: Globalization, Capital Market Crises, and Economic Reform.
8. Lall, Subir, 1997, "Speculative Attacks, Forward Market Intervention and the Classic Bear Squeeze", IMF Working Paper.
9. Lopez-Mejia, Alejandro, 1999, "Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses", IMF Working Paper.
10. Tanzi, Vito, 1997, "The Changing Role of the State in the Economy: A Historical Perspective", IMF Working Paper.
11. Treuherz, Rolf Mario, 2000, "The Crisis Manual for Emerging Countries", Fabrizio Publications.