

American University  
SIS-458/658, ECON-496/696, Spring 2012  
Tuesdays 5:30-8:00 PM

## **FINANCIAL ISSUES IN LATIN AMERICA**

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Office hours (SIS #220): Tuesdays and Wednesdays 2-5PM and by appointment

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### ***Course description***

Systemic financial problems – fiscal, banking, currency and debt crises, often in highly damaging combination – have loomed large in the economic history of Latin America. Every couple of years some Latin American country or other managed to get itself into serious financial trouble. Lately, however, there have been no banking or currency crises in the region, and on the contrary the headlines generated have been mostly favorable. What explains the past macroeconomic instability in Latin America and the recently stable macrofinancial situation? We delve into this question by analyzing both the fundamental and precipitating causes of Latin America's past financial crises, focusing on economic policy and institutional shortcomings (in the fiscal, monetary, banking and exchange-rate areas), as well as on other domestic and external forces, that combined to generate macrofinancial instability. We then use specific case studies to go more in depth into particular situations encountered in recent years. By the end of the course, you will have a clear understanding of how several key financial vulnerabilities were overcome, and why others are still latent. You will have distilled important economic policy lessons that are applicable not only in Latin America but in the rest of the world, as well.

The learning objective of this course, which will be tested in various ways, is familiarity with the essential vocabulary, analytical tools, theoretical concepts, practical applications, institutional features, and economic policy aspects of macrofinancial issues in Latin America. The expected learning outcomes are the ability to apply concepts and theories from macroeconomics to explain trends and illuminate policy issues in Latin America and elsewhere, and the sharpening of your analytical and problem-solving skills, as demonstrated in True/False and multiple-choice examinations, as well as the execution of an original essay-writing project.

### ***Course requirements and grading***

This is primarily a lecture course, although we will start each class by talking about whatever financial issues are in the news in Latin America, and your participation in this segment and in the lecture follow-up discussion is very much welcomed. In order to

reap the benefits from the course, you should plan on attending every class and on doing all of the required readings before coming to class. To encourage reading ahead of class, there will be a few “surprise” True/False quizzes handed out during the semester, at the start of some of the classes. There is no need to purchase any books; all the required readings are posted on Blackboard.

The other course requirements are two exams to take place on Tuesday, March 6<sup>th</sup> and May 8<sup>th</sup>, respectively, and one essay of a *maximum length of 2,000 words* written on one of the three topics specified at the end of this syllabus, to be uploaded to Blackboard (see “Assignment”) by 5:30 PM on Tuesday, May 1<sup>st</sup> at the latest. The quiz results will contribute to 15% of the final grade; the exam scores will weigh 30% and 25%, respectively; and the essay will account for the final 30%.

The final grade distribution will be curved to reflect the performance of the class. The top-scoring third of the class will be assigned an A or A- letter grade; most of the remainder will receive a grade in the B- to B+ range, with the exception of those scoring substantially below the class mean/median, who are likely to earn a lower final grade.

Standards of academic conduct are set forth in the University’s Academic Integrity Code (AIC). By registering for this course, you have acknowledged your awareness of the AIC, and you are obliged to become familiar with your rights and responsibilities as defined by the Code. Violations of the AIC will not be treated lightly, and disciplinary actions will be taken should violations occur. Please contact me if you have any questions about the academic violations described in the Code in general or as they relate to particular requirements for this course, and I encourage you to familiarize yourself with the AIC: <http://www.american.edu/provost/registrar/regulations/reg80.cfm>. Finally, please let me know if you become aware of any violations of the AIC.

In the event of an emergency, American University will implement a plan for meeting the needs of all members of the university community. Should the university be required to close for a period of time, we are committed to ensuring that all aspects of our educational programs will be delivered to you. These may include altering and extending the duration of the traditional term schedule to complete essential instruction in the traditional format and/or use of distance instructional methods. Specific strategies will vary from class to class, depending on the format of the course and the timing of the emergency. I will communicate class-specific information to you via AU e-mail and/or Blackboard, and you are responsible for checking your AU email on a daily basis and for keeping yourself informed of any declared emergencies. Please refer to the AU Student Portal, the AU Web site (<http://www.american.edu/emergency//>) and the AU information line at (202) 885-1100 for university-wide information.

## ***Schedule and reading***

### **January 17: Background**

#### *Required readings:*

1. John Lyons and Paulo Trevisani, "Brazilians, the Real Spenders," The Wall Street Journal, December 21, 2011.
2. Matt Moffett, "A Rags-to-Riches Career Highlights Latin Resurgence," The Wall Street Journal, November 15, 2011.
3. Sebastian Edwards, Left Behind: Latin America and the False Promise of Populism (Chicago: Univ. of Chicago Press, 2010), excerpt.
4. ECLAC, Preliminary Overview of the Economies of Latin America and the Caribbean 2011 (Santiago: United Nations, December 2011), excerpt #1.

### **January 24: The missing financial crisis**

#### *Required readings:*

1. Arturo C. Porzecanski, "Latin America: The Missing Financial Crisis," ECLAC Washington Office Studies and Perspectives Series #6 (Santiago, Chile: United Nations, October 2009).
2. IMF, "Why Has Latin America and the Caribbean Fared Better This Time?," Regional Economic Outlook: Western Hemisphere, October 2009.

### **January 31: Fiscal fundamentals**

#### *Required readings:*

1. OECD Development Center, "Recent Trends in Latin America's Fiscal Performance," in Latin American Economic Outlook 2009 (Paris: OECD, 2008), Chapter 2.
2. ECLAC, Preliminary Overview, excerpt #2.
3. Mauricio Villafuerte et al., "Riding the Roller Coaster: Fiscal Policies of Nonrenewable Resource Exporters in Latin America and the Caribbean," IMF Working Paper WP/10/251, November 2010.
4. Sebastián Nieto-Parra and Javier Santiso, "Revisiting Political Budget Cycles in Latin America," OECD Development Center Working Paper #281, August 2009.
5. Ricardo Hausmann, "Good Credit Ratios, Bad Credit Ratings: The Role of Debt Structure," in Rules-Based Fiscal Policy in Emerging Markets, ed. by George Kopits (New York: Palgrave MacMillan, 2004).

## February 7: Monetary and exchange-rate policies, Part 1

### *Required readings:*

1. Anoop Singh, et al., “Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience Since the Early 1990s,” IMF Occasional Paper #238, 2005, Chapters IV (“Monetary and Exchange Rate Regimes”) and VI (“Financial Dollarization in Latin America”).
2. ECLAC, Preliminary Overview, excerpt #3.
3. Ari Aisen, “Money-Based vs. Exchange-Rate-Based Stabilization: Is There Space for Political Opportunism?” IMF Staff Papers, September 2007.
4. Cameron G. Thies and Moisés Arce, “The Politics of Exchange-Rate Based Stabilization vs. Structural Reforms in Latin America,” Comparative Political Studies, September 2009.

## February 14: Monetary and exchange-rate policies, Part 2

### *Required readings:*

1. Jorge Iván Canales-Kriljenko et al., “Weathering the Global Storm: The Benefits of Monetary Policy Reform in the LA5 Countries,” IMF Working Paper WP/10/292, December 2010.
2. Charles Freedman and Inci Ötoker-Robe, “Important Elements for Inflation Targeting for Emerging Economies,” IMF Working Paper WP/10/113, May 2010.
3. Mark Stone et al., “The Role of the Exchange Rate in Inflation Targeting Emerging Economies,” IMF Occasional Paper 267, 2009, excerpt.
4. Mercedes García-Escribano and Sebastián Sosa, “What is Driving Financial De-dollarization in Latin America?,” IMF Working Paper WP/11/10, January 2011.

## February 21: Banking crises

### *Required readings:*

1. Anoop Singh, et al., “Stabilization and Reform in Latin America,” op. cit., Chapter V (“Latin American Financial Systems: Crises and Reforms”).
2. Luis I. Jácome, “Central Bank Involvement in Banking Crises in Latin America,” IMF Working Paper #WP/08/135, May 2008.
3. Inter-American Development Bank, Unlocking Credit: The Quest for Deep and Stable Bank Lending (Washington, DC: IADB, 2004), Chapters 3 (“Determinants and Characteristics of Banking Crises”), 5 (“Banking Crisis Resolution”) and 10 (“Foreign Banks”).
4. IMF, “Looking at the Last Credit Cycle to Better Manage the Next One,” in Western Hemisphere Regional Economic Outlook, October 2010.

## **February 28: Role of capital flows**

### *Required readings:*

1. Anoop Singh, et al., "Stabilization and Reform in Latin America," op. cit., Chapter VII ("External Vulnerabilities").
2. ECLAC, Preliminary Overview, excerpt #4.
3. John Lyons, "Dark Side of Brazil's Rise," The Wall Street Journal, September 13, 2011.
4. Ana Fostel and Graciela Kaminsky, "Latin America's Access to International Capital Markets: Good Behavior or Global Liquidity?" in Current Account and External Financing, ed. by Kevin Cowan et al. (Santiago: Central Bank of Chile, 2008).
5. Roberto Cardarelli et al., "Capital Inflows: Macroeconomic Implications and Policy Responses," Economic Systems, December 2010.
6. Nicolás Eyzaguirre et al., "Managing Abundance to Avoid a Bust in Latin America," IMF Staff Discussion Note SDN/11/07, April 2011.

## **March 6: Mid-Term Exam: Multiple-choice questions**

## **March 13: No class meeting: Spring Break**

## **March 20: Case study: Development of local bond markets in Mexico and beyond**

### *Required readings:*

1. Serge Jeanneau and Carlos Pérez Verdia, "Reducing Financial Vulnerability: The Development of the Domestic Government Bond Market in Mexico," BIS Quarterly Review, December 2005.
2. Eduardo Borensztein et al., editors, Building Bond Markets in Latin America: On the Verge of a Big Bang? (Cambridge, MA: MIT Press, 2008), Chapter 1.
3. Serge Jeanneau and Camilo E. Tovar, "Latin America's Local Currency Bond Markets: An Overview," in New Financing Trends in Latin America, BIS Papers #36, February 2008.
4. Serge Jeanneau and Camilo E. Tovar, "Financial Stability Implications of Local Currency Bond Markets: An Overview of the Risks," in *ibid.*, pp. 65-87.
5. Jonathan J. Levin and Andres R. Martinez, "Muni Bond Market Emerging as States Struggle to Repay Loans," Bloomberg News, August 24, 2011.

## **March 27: Case study: Inflation targeting in Brazil, Chile, Colombia and Peru**

### *Required readings:*

1. Luis F. Céspedes and Claudio Soto, "Credibility and Inflation Targeting in Chile," in Monetary Policy under Inflation Targeting, ed. by Frederic Mishkin and Klaus Schmidt-Hebbel (Santiago: Banco Central de Chile, 2007).

2. Afonso S. Bevilaqua, Mário Mesquita and André Minella, "Brazil: Taming Inflation Expectations," in Monetary Policies and Inflation Targeting in Emerging Economies, ed. by Luiz de Mello (OECD: Paris, 2008), Chapter 2.
3. Andrés González and Franz Hamann, "Lack of Credibility, Inflation Persistence and Disinflation in Colombia," Desarrollo y Sociedad, 1<sup>st</sup> Semester 2011.
4. Adrián Armas and Francisco Grippa, "Targeting Inflation in a Dollarized Economy: The Peruvian Experience," in Financial Dollarization: The Policy Agenda, ed. by Adrián Armas et al. (New York: Palgrave MacMillan, 2006).

### **April 3: Case study: The "hard" peg in Argentina**

*Required readings:*

1. Michael Mussa, Argentina and the Fund: From Triumph to Tragedy (Washington, DC: IIE, July 2002), Chapters 1, 2 and 3.
2. Guillermo A. Calvo, Alejandro Izquierdo and Ernesto Talvi, "Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons," in Monetary Unions and Hard Pegs, ed. by Volbert Alexander (New York: Oxford Univ. Press, 2004).
3. Arturo C. Porzecanski, "Argentina: The Root Cause of the Disaster," ABN AMRO Emerging Markets Fortnightly, July 24, 2002.

### **April 10: Case study: Banking crisis in Venezuela**

*Required reading:*

1. Ruth de Krivoy, Collapse: The Venezuelan Banking Crisis of 1994 (Washington, DC: Group of Thirty, 2000), Chapters 1-5.
2. Ruth de Krivoy, "The Venezuelan Banking Crisis: Epilogue," Toronto International Leadership Centre for Financial Sector Supervision, 2003.

### **April 17: Case study: Capital controls in Brazil, Chile and Colombia**

*Required readings:*

1. Chikako Baba and Annamaria Kokenyne, "Effectiveness of Capital Controls in Selected Emerging Markets in the 2000s," IMF Working Paper #WP/11/281, December 2011.
2. Bernardo S. de M. Carvalho and Márcio G.P. Garcia, "Ineffective Controls on Capital Inflows under Sophisticated Financial Markets: Brazil in the Nineties," in Financial Markets Volatility and Performance in Emerging Markets, ed. by Sebastian Edwards and Márcio G.P. Garcia (Chicago: Univ. of Chicago Press, 2008).
3. Kevin Cowan and José de Gregorio, "International Borrowing, Capital Controls and the Exchange Rate: Lessons from Chile," in Capital Controls

and Capital Flows in Emerging Economies, ed. by Sebastian Edwards (Chicago: Univ. of Chicago Press, 2007), pp. 241-296.

4. Kristin J. Forbes, "One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms," Journal of International Economics, April 2007.

#### **April 24: Case study: Debt defaults in Argentina and Uruguay**

*Required reading:*

1. Federico Sturzenegger and Jeromin Zettelmeyer, Debt Defaults and Lessons from a Decade of Crises (Cambridge, MA: MIT Press, 2006), Chapters 1, 2, 8 and 10.
2. Arturo C. Porzecanski, "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default," Chicago Journal of International Law, Summer 2005.

#### **May 1: E-mail versions of essay due by 5:30PM**

#### **May 8: Final Exam: Multiple-choice questions on material covered since Spring Break**

#### **Instructions for the Essay Assignment**

Choose one of the three topics detailed below for your 2,000-word paper, which *must demonstrate the application of concepts learned in class* and should make use of articles from this syllabus plus at least six (6) scholarly, academic or official sources that you have found on your own. You may cite articles or other materials from newspapers, magazines, NGO websites, and respectable blogs but they do not count toward the aforementioned minimum.

Any and all footnotes, bibliography, tables or charts you come up with are excluded from the 2,000-word maximum. Any articles or books you cite should be fully identified, preferably in a bibliography at the end where they are listed in alphabetical order by the last name of the author, followed by the year, title, publisher, month/day, and URL, if available. For example:

Forbes, Kristin J. (2007), "One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms," Journal of International Economics, April, pp. 294-323, <http://web.mit.edu/kjforbes/www/Papers/One%20Cost%20of%20Chilean%20Capital%20Controls-JIE.pdf>

Sturzenegger, Federico and Jeromin Zettelmeyer (2006), Debt Defaults and Lessons from a Decade of Crises (Cambridge, MA: MIT Press).

All facts, opinions, quotations, and paraphrasing of material that are not your own must be credited to the original source, by way of an in-line citation to a source appearing in your bibliography and to a specific page number, in order to avoid even the appearance of plagiarism. For example:

As is well known, foreign direct investment in Chile actually dropped very little after the imposition of a penalty on capital inflows in the mid-1990s (Forbes 2007, p. 301).

Footnotes should be used when you wish to expand on a point made in the text, and they should be numbered consecutively. For example:

<sup>12</sup> Foreign direct investment in Chile actually dropped very little after the imposition of a penalty on capital inflows in the mid-1990s (Forbes 2007, p. 301).

Please use Word software and activate its spell-check feature; specify single-line spacing; use page numbering; include your name in the file name and also at the top of your paper; and make sure your spelling, vocabulary, grammar, and punctuation are the best that they can be. You will only have one chance to upload your essay on Blackboard (see “Assignment”), so do not submit a first draft thinking that you can upload a revised version later. Late and/or sloppy submissions will be penalized.

### **Choice of Essay Topics:**

1. Your boss, the newly appointed Minister of Finance, suggests that since revenues are booming and funding is so plentiful and cheap in both in the domestic and international capital markets, this is a great time to grant major salary increases to teachers, policemen and other underpaid civil servants. Write her a memorandum (start with To/From/Subject/Date) explaining and justifying why doing that now would not be wise from a macroeconomic management perspective.
2. Your boss, a senior IMF official responsible for Latin America, is wondering whether the Fund should insist forcefully that *all countries in the region* that have not done so already should now shift to a strict inflation-targeting regime. Before making this decision, however, she wants to hear a contrarian view, so write her a memorandum (start with To/From/Subject/Date) detailing and justifying *the case against* the universal adoption of inflation targeting in Latin America.
3. Your boss, the relatively inexperienced President of a central bank who is also the supervisor of the country’s banks, has been informed that there is a large bank whose profitability has been eroded and which may soon start posting operating losses. He wonders out loud what few things he could do in the little time that may be left to help preserve the country’s financial stability – just in case the management of the bank in question comes knocking at his door asking for a bail-out. Write him a memorandum (start with To/From/Subject/Date) detailing and justifying what he should do *in the days and weeks ahead* to help prevent or prepare for that eventuality.