

## COMMENTS ON SESSION 1

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The purpose of the Quispe-Agnoli/McQuerry paper is to measure the magnitude of financial liberalization in five Latin American countries, specifically Argentina, Brazil, Chile, Mexico, and Peru, using data from the early 1980s through 2000 and comparing the results with those of three developed economies—Canada, New Zealand, and the United States. This is an interesting topic and a challenging task, and the paper represents a promising contribution to the literature on the subject.

Financial liberalization is evaluated by building an index of financial deepening using the Stock and Watson leading indicators methodology, based essentially on four macrofinancial indicators: (1) nominal interest rates, (2) commercial bank assets (as a percentage of total financial assets), (3) liquid liabilities (as a percentage of GDP), and (4) private credit by commercial banks (as a percentage of GDP).

### **The Quispe-Agnoli/McQuerry Paper**

**Why an Index of Financial Deepening?** The idea of explaining the link between financial development and growth is very complex. Are we sure that these four macro-financial variables are totally orthogonal or independent of each other? There is no reference to any test examining this issue in the paper. Any collinearity among variables will make the index and its growth rates excessively volatile. This is almost surely the case for the emerging country sample considered.

**What about Other Variables?** The first thing that comes to mind when someone mentions financial liberalization is banks. Are there any restrictions on foreign institutions that want to establish operations in the countries under study? What are the legal requirements to enter the domestic market? Can they take advantage of scope economies by offering a broad portfolio of products to clients? Certainly some of these restrictions are still present in Latin America, and obviously the existence of these barriers, making the market harder to enter, is a decisive factor in financial development.

Other variables to consider when analyzing financial depth are stock market capitalization, interest rate spreads, some measure for financial market liquidity, new debt emissions (IPO), new bond issues from large, medium, and small businesses, the depth of the hedging or derivative market, the presence or absence of explicit deposit insurance (moral hazard), the number of financial institutions (or some measure of concentration), and the presence or absence of legal safeguards for small shareowners, just to mention a few of them.

**What Are We Really Measuring?** The authors mention that using figures for stock market capitalization produces very volatile and unstable indexes on a year-to-year basis. This result is not what you would expect if an economy is moving toward a deeper financial market. The resulting indicator should reflect a trend with very low volatility. How can we be sure that the measured index is not merely reflecting stabilization policies (for instance, Chile and Brazil are inflation targeters), especially in emerging markets with very high inflationary levels during the sample period? Or perhaps the index is reflecting the huge capital inflows of the 1990s, which drove the expansion of domestic credit.

**Links with Domestic Activity?** I don't think we are doing the right econometrics here. As I mentioned, the paper presents no exogeneity test, so it is hard to evaluate Appendix B results. Certainly working with quarterly instead of annual data should be very helpful in this regard. To generate policy implications with sixteen, or in Brazil's case, thirteen, degrees of freedom is very challenging.

**Policy Implications?** The structure of the authors' analysis leaves no room for monitoring the process of financial liberalization, suggesting it is associated mainly to growth and capital outflows. Are we sure of that? Again the exogeneity problem arises. Is growth truly exogenous, or is it a reflection of other events or policies? Are capital outflows bad? Or are they a reflection of bad policies? Are high import levels bad for Brazil or simply a reflection of fiscal deficit spending? A larger sample size and exogeneity tests will allow the authors to enrich the index with a larger set of explanatory variables and to derive more precise policy implications.

**Panel Estimation.** Given that the dependent variable is correctly defined, I suggest a fixed effect panel estimation, using quarterly data and, ideally, controlling for heteroskedasticity and serial correlation (using the Bond-Arellano routine, for instance).

**In Summary.** This paper is a contribution to the complex task of measuring and interpreting the process of financial liberalization. My suggestion to the authors is to consider additional measures (both structural and legal) of financial depth, to switch to quarterly data, and to estimate a panel by monitoring common factors affecting emerging markets, among them world economic activity, terms of trade shocks (commodity prices), and idiosyncratic fundamentals such as domestic growth, inflation, capital flows, current account, etc. This additional effort will do justice to the significant work already accomplished in this paper.

### **The Fernández-Arias/Panizza Paper**

This is a very challenging work that attempts to explain how external factors, particularly capital flows, affect economic performance in Latin America. This is certainly a difficult task given the fact that international financial markets are not in a steady state at this time. Factors are still evolving and affecting the economic environment. A world economic slowdown (the United States, Europe, Japan) is taking place, accompanied by depressed commodity prices. International financial stress is reflected through a high correlation and volatility in asset prices, and factors such as the emergence of bio-warfare, traditionally unrelated to financial markets, are also present. Moreover, these factors do not necessarily affect all our economies simultaneously, so at

this time it is hard to say if we have already experienced all of its impact. The delicate situation in Argentina, with its potential for spillover effects in Brazil and elsewhere in Latin America, remains unsolved, thus influencing agents' perceptions of future fundamentals from day to day.

One of the purposes of this paper is to offer alternative hypotheses to explain bond spreads in Latin American countries. The authors present different channels through which external financing can affect emergent country creditworthiness. They add a second and indirect effect (the creditworthiness channel) to the direct interest rate effects of changes in international policy rates. This channel unfortunately has failed to work after 2000 as lower rates have not translated into improved creditworthiness. A third channel, which receives great attention in the paper, is contagion. Contagion is a very general and ambiguous concept, which must account for the unexplained part of every traditional econometric representation during the late century, as bubbles did during the early 1900s. Certainly, financial integration and economic globalization have contributed to develop this concept. Immature financial markets, which are characterized by illiquid instruments and are small by international standards, can trigger a big response in domestic financial markets as a result of changes in international portfolio allocations. There is a great deal of empirical work to be done if one wants to evaluate the effects of contagion.

In line with this, the authors mention factors that could explain recent trends in sovereign spreads. My recommendation here is to try to explain country spreads using solvency and liquidity factors and identifying domestic and external variables. I suggest using a panel of specific country-date observations, considering, for example, international reserves over imports, external debt over GDP, short-term debt (or debt services) over international reserves, and total imports over GDP. Domestic factors to consider (reflecting internal macroeconomic stability) could be growth, inflation, interest rates, nominal exchange rate volatility, and fiscal deficit over GDP. Finally, to evaluate the role of external factors in the determination of Latin American spreads, they might consider controlling for international growth, short- and long-term interest rates (yield curve spread), stock price volatility, and commodity prices. All of these variables may possibly help to explain changes in key determinants of country-specific spread performance over time, differentiating between domestic (idiosyncratic) and external (common) explanatory factors.

The authors also analyze the recent proposal for reforming the international financial architecture, which places great emphasis on moral hazard problems. They believe that the typical policy recommendations inherent to this view would lead not to greater financial stability but to the opposite. They claim that reforms inspired by the moral hazard diagnosis will lead to lower flows but not necessarily to more stability and may be the single most important reason behind the ratcheting of bond spreads. The authors claim that to increase financial stability we need to establish an optimal balance between moral hazard considerations and the challenge of reducing the probability of a liquidity crisis through official intervention. Again, to answer this question properly, the paper should develop an empirical model to explore the origins of fluctuations in capital flows.

In summary, this is a very interesting and challenging paper that could greatly benefit from the addition of an empirical section, including some econometric work in line with the research of Min.<sup>1</sup>

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<sup>1</sup> H. Min, Determinants of emerging market bond spread: Do economic fundamentals matter? World Bank, *Policy Research Paper* No. 1899, 1998.