

ECONOMIC STABILITY POLICIES AND SOCIAL PROGRAMS

Políticas de estabilidad económica y programas sociales

Luis BRUNSTEIN¹ – Marta GIL-LACRUZ²

Rowan University, Glassboro, N. J./Universidad de Zaragoza

Abstract

In an ever more integrated world all countries face potential economic shocks from outside and social and political instability from inside. To deal with these problems many governments have adopted restrictive monetary and fiscal policies to accumulate monetary reserves while sacrificing resources away from social programs. Hence, governments trade economic stability for domestic political risk. This paper argues that the presence of such risk forces governments to adopt a heterodox, eclectic and very flexible approach to policy formation in order may maximize their chances to achieve long term social objectives.

Key words: financial instability, contagion, monetary and fiscal policy, political risk.

Resumen

En un mundo cada vez más interdependiente, los gobiernos estatales se ven avocados a enfrentar las turbulencias y riesgos económicos que se originan en el panorama internacional y la inestabilidad política que se genera en el interior de sus naciones. Una estrategia común de afrontamiento ha consistido en la adopción de políticas fiscales y monetarias restrictivas para acumular reservas monetarias, recortando los recursos dedicados a los programas sociales. Esto supone priorizar la estabilidad económica frente al riesgo político. El presente artículo expone como se pueden adoptar políticas más flexibles, heterodoxas y eclécticas que nos permitan maximizar nuestras posibilidades de conseguir objetivos sociales a largo plazo.

Palabras clave: inestabilidad financiera, contagio, política monetaria y fiscal, riesgo político.

-
1. Assistant Professor. Department of Economics Rowan University, Glassboro. New Jersey (USA). Correo electrónico: brunstein@rowan.edu
 2. Profesora Titular, Departamento de Psicología y Sociología, Facultad de Ciencias Sociales y Humanas. Correo electrónico: mglacruz@unizar.es
- Fecha de recepción del artículo: 25 de octubre de 2006. Fecha de aceptación: 22 de noviembre de 2006. Versión final: febrero de 2007.

In an ever more connected world we find forces that unite us over time: commerce, the movements of integration, technical diffusion and the financial markets. However, the uneven degree of development, the volatility of the financial markets, the different demographic rhythms of the developed and developing countries and the control over the energy resources are some of the forces that separate us. The world economy is progressively getting united but the centrifuged forces held up the potential growth that the world economy could gain and trigger the crises (Requeijo, 2002).

There is little doubt that both developed and developing countries are vulnerable to global economic fluctuations. In the last week of May 2006 rumors doubting the degree of commitment of the then recently appointed Chairman of the Federal Reserve System of the United States, Ben Bernanke, to keep inflation at bay, as his predecessor Alan Greenspan did, coupled with the uncertainty generated by the designation of Henry Paulson as the new Treasury Secretary were enough to send a ripple of fear through the channels of the global financial system that were felt in the stocks markets across the world.

In Latin America, for instance, analysts were busy trying to explain why the repercussions were different among neighbors. Some countries experienced a mild shock mitigated by timely monetary intervention while others were less able to cushion the blow. For example, while in May 30 2006 the Dow Jones fell by 1.63%, Argentina's index fell by 3.53%, Mexico's by 3.38% and Brazil's by 4.54%³. All and all, however, the impact, vis-à-vis previous shocks was mild. Various analysts argued that most countries in Latin America today have been able to accumulate enough reserves to absorb mild exogenous changes. They also argue that a solid financial position, with surpluses in their current account and government budget account, low inflation, growing economies and increasing levels of investment were, along with capital controls and a healthier debt structure leaning towards longer term structures, significant factors to protect the real economy when the funds began to flow out during the last week of May. However, further uncertainty during May and June led to a fall of 18.9% in the stock market in Turkey, 14.6% in India, 13.9% in Brazil, 10.7% in Mexico, 10% in Argentina and 6.3% in Chile⁴.

3. Clarin.com, «Temor en la City: caen la Bolsa y los bonos, y el Central frenó el dólar,» May 31, 2006, at www.clarin.com

4. Clarin.com, «El mal clima financiero le costó 1.100 millones de dólares al país,» July 13, 2006, at www.clarin.com.

Exogenous shocks give rise to financial instability which may contribute to derail the development program of a government. And while according to Schinasi (2004: 3-8) «...there is no single, widely accepted and used definition of financial stability» the author argues that «[a] financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events». According to Mishkin (1999: 6) «...[f]inancial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities». Whereas, in a broader sense financial stability implies monetary stability, employment levels close to the natural rate, confidence in the operation of key institutions and markets and where the relative prices of real and financial assets are stable (Foot, 2003).

However, exogenous shocks are just one of the problems facing economies, where certain degree of monetary and fiscal policy autonomy is needed to address unemployment and poverty issues. Hall and Taylor (2002) argue that «domestic policy —particularly the scope for adjustment to shocks through fiscal, monetary and exchange rate policies— can also influence the impact of transmitted shocks. For example, active and pre-emptive policy responses appear to have had a material impact in reducing spillovers in some countries in previous EME crises» (p. 129).

The market economy confronts two great challenges during this millennium: the weight of the public sector and the problem of unemployment. The size and intensity of the public sector's intervention are polemic questions, and while some believe it to be excessive because it exacerbates the rigidities of the economic system inhibiting productivity growth, from a different perspective it can be argued that such intervention is needed to address the many social inequalities to be found everywhere today.

Furthermore, governments that attempt to reduce external vulnerability may have to give up certain policy autonomy whereby social objectives and financial stability may mutually constrain each other within a multi-objective policy set. Shielding the economy from external risk may inhibit the attention to domestic social problem, perhaps, leading to greater political risk arising from social discontent.

By setting the forthcoming analysis largely within the theoretical framework of macroeconomic financial stability and buttressing its development on the relevant empirical literature this paper sits at the

vortex of both while attempting to characterize the fundamental tradeoffs faced by governments today when shaping economic policy. Furthermore, the paper addresses one of the central dilemmas of current stabilization policy; its opportunity cost.

The paper proceeds by characterizing the mechanism for contagion. Then, it proposes various ways to conceptualize and measure macroeconomic financial fragility. Then the paper discusses what type of policies could be used to shield the economy from exogenous shocks. The next section discusses political risk and its impact on policy formation. In the discussion section the paper tries to characterize the main issues confronting policy-makers and proposes some guidelines. The last section summarizes the main points of the paper and suggests research extensions.

1. PROPAGATION CHANNELS

Requeijo (2002) indicates six major characteristics of globalization: the rapid increase in the flow of commerce (visible and invisible), and specially the flow of capital across borders, the increasing importance of transnational corporations, the worldwide competition in almost all markets, financial and otherwise and the questioning of national policies.

In the period of time between 1989 and 2000 the international trade of goods and services and in particular that of capital has increased significantly. This was fostered by the technological development in the information and communication sectors and the fallen of economic borders. Hence, it is not surprising within this global context that financial crises are born.

Changes to monetary and fiscal policy abroad, changes in expectations, unexpected political and social events, shocks to natural resources, natural disasters and other changes affecting economic variables, real and financial, will find their way into the economies of less developed and industrialized countries affecting them in various and different ways.

The freedom of capital movement and the simultaneity of transactions facilitate the contagion tendencies across financial markets. The international diversification of portfolios, the greater integration of the markets across time zones and the increasing importance of the derivatives' markets contribute in a significant fashion to this tendency.

There are direct and indirect or secondary channels of transmission or contagion. For example, a restrictive monetary policy in the United States may induce greater capital outflows in, for example, Brazil and Argentina

as funds seek higher returns in dollar denominated deposits. This is the direct channel.

The secondary channels that have proven to be significant may be more complex to conceptualize because their profile depends on the following factors: the level of bilateral trade among the affected countries, the degree to which they share a common creditor or creditors, the degree to which they share common trade markets and the exposure of investors to their economies, Hall and Taylor (2002: 128-134), IMF (2006: ch. 3: 30-5).

De Alessi Gracio *et al.* (2005: 96-97) argue that the behavior of institutional investors contributes to propagate crises as they are forced to sell some of their instruments in various markets to cover their margin calls, reduce their portfolios' risk or reduce the risk arising from their exposure to other markets when a crisis erupts in at least one market where investors are significantly exposed. The problem is further complicated by a combination of herd behavior and rational ignorance. When some of the largest investors, presumably better informed, begin to pull away from one market the rest may follow without spending the effort to research the fundamentals, amplifying the effect of the shock in the original and connected markets. The momentum may be exacerbated by risk-averse managers whose remuneration is based on performance comparisons to other fund managers. Calvo and Mendoza (2000: 81) support these arguments.

Chui *et al.* (2004: 14) argue that «small rumors can trigger herd behavior among investors, and shift an economy from a good equilibrium to a bad one, with large capital outflows unrelated to economic fundamentals».

Kaminsky *et al.* (2003: 56-72) provide empirical evidence from five crises showing that common leveraged creditors play a significant role while propagation via trade links seems nonexistent. The data also shows that the degree of propagation depends on how markets were anticipating crises episodes. Canova (2005: 231), also finds that the trade channel is not important but monetary policy in developed countries, direct channel, is. Villar Frexedas and Vayá (2005: 15) and Van Rijckeghem and Weder (2001: 305) show, additionally, that the common lender factor is a significant propagation channel.

Contrary to other papers, Glick and Rose (1999: 604) argue that «...trade is an important channel for contagion, above and beyond macroeconomic influences. Countries who trade and compete with the targets of speculative attacks are themselves likely to be attacked».

As the literature suggests, emerging and developed economies are exposed to the rest of the world via trade and financial markets. The effects of financial and commercial crises amplified by the speculative processes will inhibit national and international investment. This phenomenon is due to various reasons: the impoverishment of investors and the contraction of expectations, the fact that the international trade of goods and services will feel the effects from them and because when the profit rate falls in one area its importation of goods and services will also fall. The sequence acquires a global dimension. The «real» consequences of these crises will be a reduction in the growth capacity and the levels of employment and profits in the affected countries, developed and developing ones (Requeijo, 2000).

Both, the trade and financial markets, particularly the latter, will develop new channels as the markets for commodities and securities evolve. By their own nature, as countries become more developed these markets will offer more complex instruments, greater depth, allowing agents to trade greater risk. Presumably then, these economies in particular will have to enhance their monitoring efforts in an attempt to reduce the impact of future crises in order to support a stable path for economic development.

2. ASSESSING MACROECONOMIC FINANCIAL FRAGILITY

All countries are vulnerable to exogenous shocks. Emerging economies may be more vulnerable because their fundamental structure is, or may be perceived to be, weaker and their regulatory system may lack some of the controls needed to deal with sudden capital flows. This is logical because in the root causes and consolidation of a crisis we already can find the loss of confidence in the country's economy due to various reasons: inability to pay the foreign debt, the persistence of strong macroeconomic disequilibria, foggy expectations regarding assets' profitability, clear signs of fragility of the financial system or the sum of all these factors. In light of this picture we need a series of economic variables that could be used to monitor the fundamental macroeconomic health of a country.

In the face of an exogenous shock funds will tend to flow out faster from those countries perceived ex-ante to have a greater risk of collapsing and a longer period of recovering. The status of the current account, the government's budget, the level of employment, investment and saving, foreign currency reserves, anti-cyclical fund accumulation, level and structure of public debt, functioning of the financial regulatory institutions, degree of enforceable capital control mechanism and political and social situation

will be used by banks and non-bank financial institutions to gauge the reliability of the system at the time of the shock. Like a person who contracts a virus, the healthier the body the shorter it will take for the individual to recover.

According to Hilbers *et al.* (2000: 53), «...data on aggregate and sectoral growth, trends in the balance of payments, the level and volatility of inflation, interest and exchange rates, the growth of credit, and changes in asset prices, especially stock and real state prices...» along with information regarding the vulnerability of the financial system and indicators of contagion and investor behavior are all relevant macroeconomic indicators to assess the country's ability to cope with capital flow reversals and currency crises. The quality of regulatory institutions, including the legal infrastructure should also be part of the analysis. And the authors add that «...assessments need to be based on a comprehensive set of indicators, taking into account the overall structure and economic situation of a country and its financial system» (pp. 53-54).

Grabel (2003: 252-3 and 2004: 28-30) argues that an exogenous shock leading to a rapid devaluation of the domestic currency may have a significant effect on the ability of domestic borrowers to repay foreign-currency denominated debt. This in turn may amplify the initial effect of the shock giving rise to a massive sell off of assets as panic ensues and possibly promoting and amplifying the initial contagion effect. Hence, exposure to the risk of foreign currency fluctuations needs to be continuously assessed by the monetary authority.

The International Monetary Fund's, IMF, Global Financial Stability Report introduces a series of variables to assess financial fragility: volatility measures, debt cross correlations, equity indexes, returns on bonds and global yield spreads, and other financial soundness indicators for emerging markets (Statistical appendix, 2006: 163-195).

3. POLICIES TO DEAL WITH EXOGENOUS SHOCKS

The importance of having an economy the either seems to be in good shape, or at least one that is able to portray an image of strength to the world, has been established earlier in this paper as an important factor in shaping the expectations and, consequently, the behavior of economic actors, in particular institutional investors, in the face of an exogenous shock. Obviously any government is not only concerned with the cosmetic aspects of the model as the fundamental variables do change partly in response to

the workings of an economic program rather than to intended manipulation alone.

Aside from reaping the benefits stemming from window dressing governments could engage in various explicit policies in an attempt to isolate the economy from external changes. In past decades governments had at their disposal a series of policies that would allow them to modulate the economic activity: monetary, fiscal and political strategies.

In a globalized context the efficiency of domestic policy is difficult to evaluate. «For the case when the national interest is not validated by the international financial markets, the value of the currency will suffer, with undesired appreciations or depreciations and the ensuing effects on the current account balance and the level of prices. If taxes increase, to pay for an increasing public sector's expenditure, it would be possible for some part of the national capital to leave the country and that some corporations would do the same to maintain their competitive level; if taxes do not increase, to avoid the mentioned consequences, then the government's budget deficit will increase and consequently interest rates and inflation, so investment will suffer, leading to a deterioration of, again, the current account balance (Requeijo, 2002: 341).

The accumulation of international reserves to defend the domestic currency during capital flight episodes along with the limited use of capital control tools may contribute to partly shield the economy from exogenous shocks. The Central Bank could also implement a policy to change the structure of the public debt towards longer maturity along with the emission of debt denominated in domestic currency in an attempt to decrease the exposure of public finances to currency fluctuations.

In sum, the monetary authority could take a battery of measures, consistent with the current literature, to minimize the impact of exogenous shocks on the financial and ultimately the real sector of the economy. However, shocks could also be generated internally as a consequence of unstable socio-economic conditions leading to political instability. This source of risk is important and must be taken into consideration by the policy-makers.

4. POLITICAL RISK

It has been accepted by the literature on financial risk that the political and social situation of a country is at least as important as the state of its finances. Lensink *et al.* (2002) find a robust correlation between political

risk and capital flight. Kashiwase and Kodres (2005: 43) incorporate government stability, socioeconomic conditions, external conflict, internal conflict, corruption, military in politics, law and order and bureaucratic quality among the political risk rating variables used in their regression analysis. Erb *et al.* (1996, 1999) include political risk into the analysis of bond spreads and Bilson *et al.* (2002: 1) argue that «...political risk is important in explaining return variation in individual emerging markets...» Along with the IMF's Global Financial Stability Report the papers utilize the data provided by the Political Risk Services. Le and Zak (2006: 308) state that «...political instability is the most important factor associated with capital flight». The authors argue that political risk is captured by socio-political instability and regime change (p. 314).

An unstable social situation, such as high unemployment and chronic poverty may promote political instability leading to uncertainty about the government and its economic plan, Tokman (2003: 95-96), Holzmann and Jorgensen (1999: 22-23), Stiglitz (2003: 27-28). As analysts revise their risk factors capitals may modify the speed and direction of their flow affecting the real economy via changes in currencies and interest rates and amplifying the effect through the country-specific sentiment component. The length and gravity of the ensuing crises following a shock will depend on the initial economic and political conditions at the time of the shock, internal and external, and the history of the country.

The internal dynamics of the momentum propelling the inertia of chronic poverty in some countries may map itself into decreasing policy credibility and ultimately political resistance leading to greater political risk. Henceforth, policies addressing poverty and unemployment, above and beyond those that favor market-based incentives for direct investment, should become a *de facto* component of a complex set of policy measures within the larger framework of prudential risk management. In other words, governments may need to assume a proactive role in order to support the path to achieve their policy goals.

Undoubtedly, thanks to the Keynesian legacy and its theory regarding the failures of markets, in many developed countries government intervention is recognized to be important in three significant areas: public goods, distribution of resources and to stabilize economic growth (Musgrave, 1992):

- The provision of public goods is in regards to those goods and services that are available to all citizens, where no one can be excluded from consumption and they are non-rivalrous in consumption, for example national defense and the space research program.

- The government attempts to mitigate the socioeconomic inequalities generated by the market by caring for the less favored groups in society via the provision of free education, public health and pension plans. The principle of equality guides the government's effort.
- Governments concerned with the achievement of sustained growth of production and profits tend to stabilize the national economy in order to maintain a high level of employment. They try to avoid sudden falls in economic activity associated to the cycle and mitigate the effects of the change. Monetary and fiscal policies are the main tools of a stabilizing policy but not exclusively because others such as a currency control mechanism may also contribute in the effort.

Conceptually the policy-maker faces the ongoing dilemma of having to choose between allocating resources to obtain additional units of risk insurance versus diverting funds towards improving social conditions. In this sense, it is relevant to mention the evolution of the concept of capital and investment in human resources and social conditions for the OECD, Organization of Economic Cooperation and Development (2001). In the human capital concept we find knowledge and individual motivation. In the social capital concept they include the norms and networks that facilitate the cooperation between and within groups, consequently decreasing the socioeconomic inequalities. The relationship between human and social capital and economic growth has been shown in several studies (Barro, 2001, Durkin, 2000, Hanushek y Somers, 2000, Temple, 2001, Veenstra, 2001, Wasmer, 2001).

However, it is extremely difficult to find and measure social capital due to the variability, context and characteristic of the process (Bankston and Zhou, 2002).

Ironically, both policies, contractionary and expansionary, can increase political risk if implemented outside a sort of «optimally balanced range». Finding this «balance» requires a continuous close reading of the local economy contextualized by the global conditions. In any event, the experience of the context generates the knowledge, practices and alternatives of progress that simultaneously adjust themselves to the conditions within which people and groups live with each other (Campbell and Jovchelovitch, 2000).

In other words, in the face of potential destabilizing threats to the economic program from outside and inside policymakers are forced to implement a sort of risk management approach to policy formation. This means that a choice must be made among the set of social programs in

need of attention whereby a ranking of priorities could be used as an instrumental method to allocate scarce resources. However, the degree of instability outside each country also plays a fundamental role in each domestic economic program. Whereby the initial economic, social and political conditions in each country combined with the magnitude and frequency of the exogenous shocks will play a major role in constraining the ability of each government to address their domestic social problems. This is the central problem faced by most countries today when designing macroeconomic policy.

5. DISCUSSION

The discussion presented above suggest that monetary policy could be hijacked by its own purpose away from its expansionary capacity to accomplish the dual goal of simultaneously stabilize relative prices and to minimize the impact on them, and in turn on the real economy, arising from exogenous shocks.

Fiscal policy is constrained by the need to accumulate international reserves and to form an anti-cyclical fund. Both funds provide a degree of financial robustness and support such perception in the eyes of investors. This means that even if a country has been growing at a fast pace and even if tax revenues have increased the government's ability to redirect the newly created wealth is limited by its own stabilization policy.

The limited ability of monetary and fiscal policy to reduce the levels of unemployment and poverty above and beyond what the market mechanism and the structure of the economy can bear essentially characterizes the central problem being faced by the government. The internal dynamics of the system suggest that for such policy to be successful in the long run it needs to yield enough improvement in the unemployment and poverty indexes to mitigate a political backlash and ensuing risk that may arise from it otherwise.

For some time now the theory of public choice has argued that politicians will offer their constituencies programs and policies in exchange for their votes⁵. The demand on the politicians is compounded by the reaction that

5. For example - Downs A., «An Economic Theory of Democracy». New York, Harper, 1957.
— Buchanan, J. y G. Tullock, «The Calculus of Consent: Logical Foundations of Constitutional Democracy». University of Michigan Press, 1962.
— Niskanen, W. Bureaucracy and Representative Government. Chicago, Aldine Atherton, 1971.

the common citizen has when facing various market failures, the pollution advocacy groups, the power sported by monopolies and the central role played by the media.

But the criticisms to the restrictive fiscal policies and the functioning of the welfare state are always easier to address than the risks arising from a non interventionist policy. For example, in the case of unemployment, according to the OECD there are three pernicious factors that threaten the entire society: First, the economic cost that can be decomposed into two elements, forgone production and crisis of the system.

Second, there is a social cost associated to unemployment that is difficult to measure. Not only income falls, along with the quality of life, but it is accompanied but a worsening of the expectations, in particular for the middle class. The most affected groups run the risk of falling into the trap of poverty, out of which they would have a very difficult time escaping. Social cohesion would be damaged as those who remain employed would see the unemployed group as a fiscal threat. In the city where ghettos are formed by the less favored people unsafe conditions are constant factors.

The third factor is one of political nature: the survival of democracies requires the support of the people. If the system is not supported by an ample social base the totalitarian temptation could materialize itself. Unemployment and poverty are threats to our social achievements and social rights and they require urgent government action.

This should demand a constant monitoring of the social and political conditions of all social classes in the country in order to manage political risk appropriately. In other words, this risk needs to be managed and characterized like any other risk.

This suggests that a trade off exists, that some aspects of the policy could be altered to mitigate the long run political risk associated with the negative externalities arising from structural poverty and unemployment such as economic crime and perpetual exclusion.

A slight modification of this policy may include a more dynamic conception of internal financial flows whereby resources do not sit idle, or earning nominal fees, but rather flow sporadically to nodes in the system where risk factors are beginning to mount above prudential levels. For example, a portion of the fiscal surplus could be used as temporal collateral to extend credit to small domestic ventures that are labor intensive in order to reduce unemployment in an impoverished locality without increasing risk in the banking system. In other words, credit could be extended to

higher risk groups without affecting the integrity of the banking system. This would amount to a sort of macroeconomic prudential risk management technique where the market provides signals and incentives and the public sector acts as a backstage catalytic instrument, thereby minimizing market distortions.

Similar arguments have been launched whereby the optimality of reserve accumulation has come under scrutiny. The main argument is that many developing countries have been accumulating more than traditional benchmarks, measured in terms of months of imports for example, and that the excess could be put to better use. The literature, along with this paper, disagrees on benchmarks and measurements, but agrees on that developing countries in particular can do better than simply holding dollars or highly liquid low-yield instruments.

Rodrik (2006) argues that there is a social cost to pay for holding excess reserves and posits that capital controls may be used as a tool to stabilize flows without sacrificing the opportunity cost of holding foreign currency, but acknowledges that capital controls are politically less feasible. Summers (2006) also believes that reserves are too high in many countries and calls for a reform in their strategies. Hauner (2005) attempts to measure the opportunity cost of holding reserves and argues that countries should diversify their holdings into instruments with longer maturities. Aizenman and Lee (2005) argue that most developing countries hold excess reserves mostly as a precautionary measure, a self-insurance.

On a slightly different approach García and Soto (2006) argue that the levels of reserves need to be compared to the potential cost of a crisis. From their perspective most countries are holding adequate levels. Their method controls for the quality of political institutions and concludes that it is better to be liquid than to depend on the technocrats to solve a shortage of cash. This also may, to some extent, be a sentiment at the Central Bank. Their argument supplements the agency problem argued in Summers (2006). The Chairman of any Central Bank may take a riskier approach and allocate some of the reserves into higher-yield instruments. However, they will not do so because the public recognition from earning greater returns on the bank's reserves is significantly lower than the derision they will get if they earn negative rents. Then it becomes a rational choice to act conservatively unless the terms for chairmanship become long enough to provide additional incentives for them to take additional risks, but this may introduce moral hazard problems. Higher returns may be earned in the long run, but the Chairman's election cycle may not coincide with the business cycle.

The combination of extreme precaution, fear of corruption and agency issues combined may partially explain why monetary policy in many countries seems to be overly conservative to the point of becoming either irrational or suboptimal. But, the importance of all these factors ought to be assessed on the country by country bases.

A crucial question then arises: can, or will, the government, any government in general today, deviate significantly from the current precautionary policy without increasing the risk of fomenting additional doses of financial instability?

This paper argues that the answer is no. The cost of the policy is not negligible, but it is not clear at this point that reallocating these resources to other uses would yield greater pay offs to the country. A more aggressive redistribution policy may alleviate the pain of some portion of the population for a limited time but may expose the country to cycles of volatility and capital outflows, sudden stops, thereby defeating the policy's main objective and setting the bases for greater levels of political risk. Additionally, without the proper complementary policies, funds transfers could amount to nothing more than dumping money and harvesting corruption and expectations of future transfers leading to greater political risk as the government is unable to meet expectations.

One option is for the government to identify those programs that affect groups that pose a higher political risk. That may be amoral but rational and may lead to long term effects of greater inequality. By caving into the demands of those groups that have a greater political clout, stronger lobbies, the government may implement policies that could increase poverty and unemployment thereby defeating its own agenda. Woo (2003) supports this argument. On the other hand, by attempting to implement a program without, at least, enough support from the political establishment it may promote enough political risk to bring the program to a stand still.

This suggests that once political risk is considered the political feasibility of a program may play an important role in shaping the dynamics of it. In other words, the impact of the program on the socio-economic structure of the country endogenizes, among other things, the political risk. Implicitly the policy-maker will be continuously searching for a set of policies that would minimize risk while simultaneously attempting to achieve multiple and linked objectives. However, this paper does not suggest that risk analysis should dominate industrial policy and its complementary social policies, it rather suggests that risk analysis should complement the formation of policy in order to assess its feasibility, particularly in the long

run or until some horizon long enough for a set of policies to yield some tangible results.

How long can the more relegated groups wait before they act upon their frustrations? That is difficult to tell and, as argued earlier, it should not be a relevant question; it may actually be a self-defeating one. Instead, the government ought to recognize that the welfare of the entire society must be taken into consideration when designing a set of policies that aspire to achieve long run objectives. This may be done by giving appropriate weights to the various sources of risk so that in the process the set of dynamically adaptive policies may be able to fluctuate about a range of motion such that risk or the perception of it thereby, is minimized.

Following previous arguments, the greater the degree of social exclusion and the longer it exists the greater the weight it should be attached to the problem. For economies to be able to adapt to a complex and interdependent world it seems necessary to have some degree of macroeconomic stability, improve the educational system, eliminate the obstacles to the creation of entrepreneurship, invest in infrastructure and give priority to the development of social capital. These policies, among others, are incompatible with unjust and highly unequal social systems.

Expenditures on education and employment suggest a long term investment. Its classification as human capital is rooted in its intrinsic importance as a factor to optimize the technological and financial innovation framed within the development and welfare models (Gil-Lacruz and Gil-Lacruz, 2006).

To combat social exclusion and to promote cohesion should be a priority of the social policies of the developed countries (Bjørnskov, 2003; OCDE, 2001). Even though we do not have a unique measure of cohesion certain social indicators like the percentage of suicides, the violence or abuse of drugs, not only points to personal crises but also to certain environmental conditions. If in the case of addictions it can be observed that the abuse of these substances increases during times when the unemployment level is high or when the country experiences economic recessions then a connection can be made between stress and economic factors (Dee, 2001).

Therefore, the government may need to implement a dynamic approach to policy-making by continuously adapting to the internal and external changes while attempting to minimize the total risk so as to maximize its chances of achieving its various and simultaneous policy objectives. In the final analysis an eclectic approach to policy formation

may be the only real option many governments have today to clear the path towards stable development.

6. CONCLUSIONS

The main objective of this paper was to characterize the dilemma being faced by many governments when trying to maintain financial stability and simultaneously decrease poverty and increase employment in their economies before their policies lose credibility and, consequently political support.

By conceptualizing the problem as one where chronic levels of poverty and unemployment lead to political risk the paper argues that such risk ought to be part of the overall risk management approach. Hence, monetary and fiscal policies do not have to fall prey to stabilization goals thereby inhibiting their ability to address social problems but rather ought to be used to minimize financial and political risk.

In other words, the analysis presented here suggests that rather than just follow strict conservative economic programs governments will find it more advantageous to approach policy formation from an eclectic angle. This requires a constant monitoring of the economic system in order to address social and political problems as they present themselves by reallocating resources in a dynamic fashion among the various sectors of the economy.

Given that this paper characterizes the fundamental trade offs facing any economic system in a global environment a natural extension to this work would be to apply it to case and comparative studies. From an interdisciplinary perspective those authors researching the effect of social policy on poverty, immigration and social capital formation this paper should provide a global context that recognizes the fundamental impact that the flow of capital has today on the welfare of all social classes in each country, in particular the lower classes.

In the final analysis, as the Nobel Prize in Economics Manfred Max Neff said, the policymaker designing the strategies to foster economic development must always include the human dimension. It is about creating a competent environment where the wealth generated could be distributed more equitably to foster not only a more balanced development but also one that will be sustainable.

7. REFERENCES

- AIZENMAN, J. and L. JAEWOO, *International reserves: precautionary vs. mercantilists views, theory and evidence*, International Monetary Fund, working paper 198, Washington D.C., 2005.
- BANKSTON, C. and M. ZHOU, «Social capital as process: the meanings and problems of a theoretical metaphor», *Sociological Inquiry*, vol. 72 (2002), pp.285-317.
- BARRO, R. «Education and economic growth», In J. Helliwell (ed.), *The contribution of human and social capital to sustained economic growth and wellbeing*, International Development Canada and OECD, 2001.
- BERNANKE, B., *Remarks Before the Economic Club of New York*, March 20, 2006.
- BILSON, C. M., T. J. BRAILSFORD and V. C. HOOPER, «The explanatory power of political risk in emerging markets», *International Review of Financial Analysis*, vol. 11 (2002), pp. 1-27.
- BJØRNSKOV, C., «The happy few: cross country evidence on social capital and life satisfaction», *Kyklos*, vol. 56 (2003), pp. 3-26.
- BUCHANAN, J. and G. TULLOCK, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. University of Michigan Press, 1962.
- CALVO, G.A. and E.G. MENDOZA, «Regional contagion and the globalization of securities markets», *Journal of International Economics*, vol. 51 (2000), pp. 79-113.
- CAMPBELL, C. and S. JOVCHELOVITCH, «Health community and development: towards a social psychology of participation», *Journal of Community Applied Social Psychology*, vol. 10 (2000), pp. 225-270.
- CANOVA, F., «The transmission of US shocks to Latin America», *Journal of Applied Econometrics*, vol. 20 (2005), pp. 229-251.
- DE ALESSI GRACIO, C., G. HOGGARTH and J. YANG, «Capital flows to emerging markets: recent trends and potential stability implication», *Financial Stability Review*, December (2005), pp. 94-102.
- DEE, T., «Alcohol abuse and economic conditions: Evidence from repeated cross-sections of individual level data», *Health Economics*, vol. 10 (2001), pp. 257-270.
- DOWNS, A., *An Economic Theory of Democracy*. New York, Harper, 1957.
- DURKIN, J., *Measuring social capital and its economic impact*. Working Paper, University of Chicago, 2000.
- ERB, C., C. R HARVEY and T. E. VISKANTA, «Understanding emerging market bonds», *Emerging Markets Quarterly*, spring (2000), pp. 7-23.
- , «The influence of political, economic, and financial risk on expected fixed-income returns», *The Journal of Fixed Income*, vol. 6, n. 1, June (1996), pp. 7-30.
- FOOT, M., «What is «financial stability» and how do we get it?», The Roy Bridge Memorial Lecture, United Kingdom: Financial Services Authority, April 3, (2003). <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp122.shtml>
- GARCÍA, P. and C. SOTO, «Large hoardings of international reserves: are they worth it?» In R. Caballero, C. Calderón, and L. F. Céspedes (ed.), *External Vulnerability and Preventive Policies*, Santiago, Chile, Central Bank of Chile, 2006.

- GIL-LACRUZ, M. and A. I. GIL-LACRUZ, «Capital humano y capital social, implicaciones en el crecimiento económico», *Revista del Ministerio de Trabajo y Asuntos Sociales*, vol. 61 (2006), pp. 93-104.
- GLICK, R. and K.R. ANDREW, «Contagion and trade, why are currency crises regional?» *Journal of International Money and Finance*, vol. 18 (1999), pp. 603-617.
- GRABEL, I., «Predicting financial crisis in developing economies: astronomy or astrology?» *Eastern Economic Journal*, vol. 29, n. 2, Spring (2003), pp. 243-258.
- , *Trip wires and speed bumps: managing financial risks and reducing the potential for financial crises in developing economies*, paper presented at the United Nations Conference on Trade and Development (UNCTAD)/Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24) for the XVIII Technical Group Meeting of the G-24, Geneva, Switzerland, March 8-9th, 2004.
- HALL, S. and A. TAYLOR, «Spillovers from recent emerging market crises: what might account for limited contagion from Argentina?» *Financial Stability Review*, June (2002), pp. 128-135.
- HANUSHEK, E. and J. SOMERS, «Schooling, labour force quality and the growth of nations». *The American Economic Review*, vol. 90 (2000), pp. 1184-1208.
- HAUNER, D., *A fiscal price tag for international reserves*, IMF Working paper 81, International Monetary Fund, Washington D.C. 2005.
- HILBERS, P., R. KRUEGER and M. MORETTI, «New tools for assessing financial system», *Soundness Finance and Development*, September (2000), pp. 52-55.
- HOLZMANN, R. and S. JORGENSEN, *Social Protection as Social Risk Management: Conceptual Underpinnings for the Social Protection Sector Strategy Paper*, Social Protection Discussion Paper Series, The World Bank, Discussion paper 1994, 1999.
- KAMINSKY, G.L., C.M. REINHART and C.A. VÉGH, «The unholy trinity of financial contagion», *Journal of Economic Perspectives*, vol. 17, n. 4, Fall (2003), pp. 51-74.
- KASHIWASE, K. and L.E. KODRES, *Emerging market spread compression: is it real or is it liquidity?*, International Monetary Fund, working paper, October 2005.
- LE, Q. V. and P. J. ZAK, «Political risk and capital flight», *Journal of International Money and Finance*, vol. 25 (2006), pp. 308-329.
- LENSINK, R., N. HERMES and V. MURINDE, «Capital flight and political risk», *Journal of International Money and Finance*, vol. 19 (2000), pp. 73-92.
- MISHKIN, F.S., «Global financial instability: framework, events, issues», *The Journal of Economic Perspectives*, vol. 13, n. 4, Fall (1999), pp. 3-20.
- MUSGRAVE, R. P., *Hacienda Pública Teórica y Aplicada*. Madrid, McGraw-Hill, 1992.
- NIESKANEN, W., *Bureaucracy and Representative Government*. Chicago, Aldine Atherton, 1971.
- OECD, *The wellbeing of Nations: The role of human capital and social capital*. Paris, OECD Publications, 2001.
- REQUEIJO, J., *Economía Mundial*. Madrid, McGraw-Hill, 2002.
- RODRIK, D., *The social cost of foreign Exchange reserves*, Forthcoming in *International Economic Journal*, 2006.

- SUMMERS, L., *Reflections on global account imbalances and emerging markets reserve accumulation*, L.K. Jha Memorial Lecture, Reserve Bank of India, Mumbai, India, March 24, 2006.
- SCHINASI, Garry J., *Defining financial stability*, IMF working paper wp/04/187, 2004
- STIGLITZ, J.E., *Whither reform? Towards a new agenda for Latin America*, CEPAL review, n. 80, August 2003.
- TEMPLE, J. «Generalization that aren't ? Evidence on education and growth», *European Economic Review*, vol. 45 (2001), pp.905-918.
- The Political Risk Service Group at: <http://www.prsgroup.com> 2006.
- TOKMAN, V. E., «Towards and Integrated vision for dealing with instability and risk», *CEPAL Review*, 81, December (2003), pp. 79-98.
- VAN R. and B. WEDER, «Sources of Contagion: is it finance or trade?», *Journal of International Economics*, vol. 54 (2001), pp. 293-308.
- VEENSTRA, G. «Social capital and Health», *Printemps*, spring (2001), 72.
- VILLAR FREXEDAS, O. and E. Y. VAYÁ, *Financial contagion between economies: an explanatory spatial analysis*, 45th Congress of the European Regional Science Association, Vrije Universiteit Amsterdam, 23-27 August 2005.
- WASMER, E., «Measuring human capital in the labour market. The supply of experience in 8 OECD countries», *European Economic Review*, vol. 45 (2001), pp. 861-874.
- WOO, J., «Social polarization, industrialization, and fiscal instability: theory and evidence», *Journal of Development Economics*, vol. 72 (2003), pp. 223-252.