FINANCIAL GLOBALIZATION IN THE 1990s: Lessons and Policy Implications

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MORAL OR GLOBALIZATION HAZARDS?

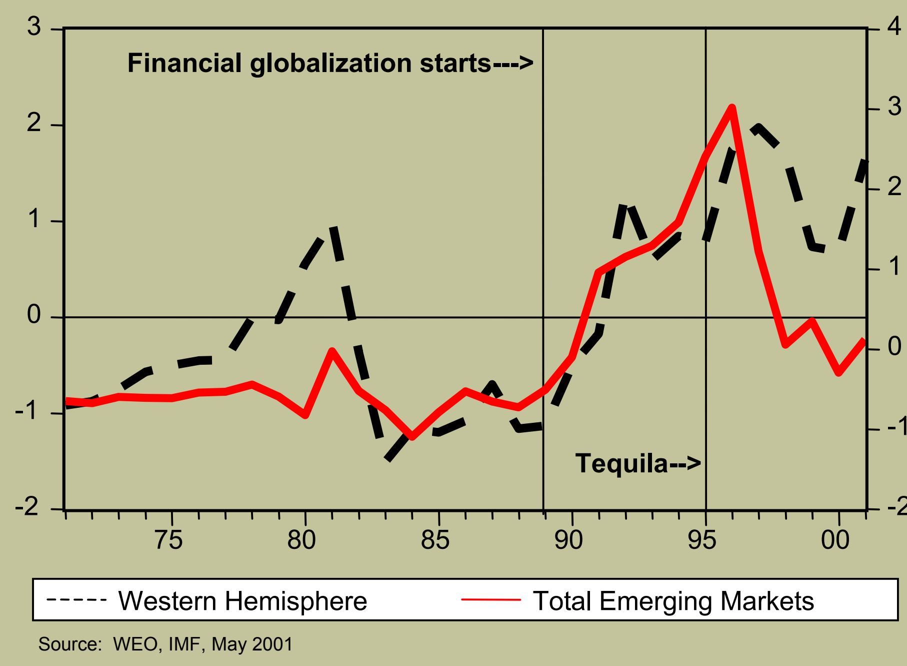
The Moral Hazard View

- Large bailouts starting with the Tequila $50 billion package, induced greater risk taking by governments and investors,
- which increased the incidence of crises.

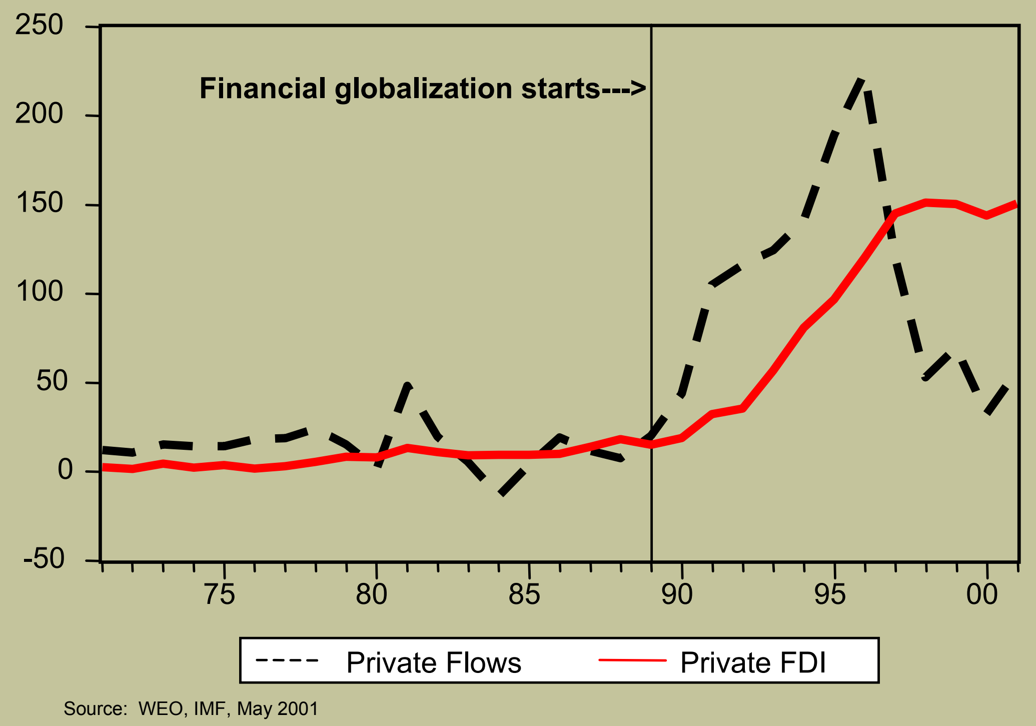
Moral Hazard: A Critique

- Capital flows to EMs started to fall a year after Tequila
- The composition of flows shifted in favor of Foreign Direct Investment

Private Net Capital Flows



Foreign Direct Investment



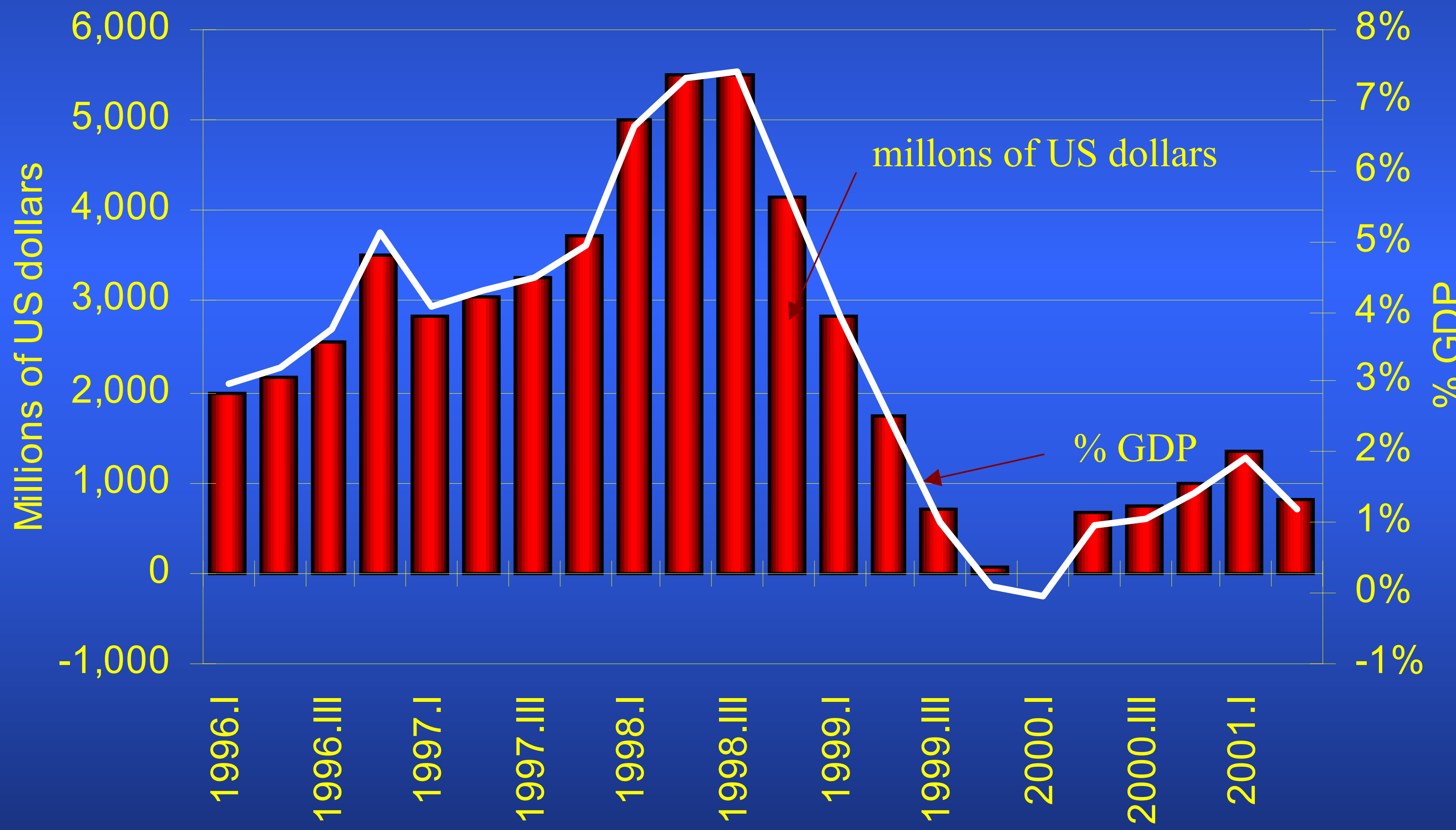
Globalization Hazard View

- Since 1989 capital flows increased at a very rapid rate, and also collapsed very sharply starting in 1996.
- Volatility was high, and capital flow reversals reached record-high levels
- Current account adjustments are much bigger in EMs than in Advanced Economies.
- **Crises could reflect institutional and informational features that apply especially to EMs.**

SUDDEN STOP: A *Tornado* in Capital Markets

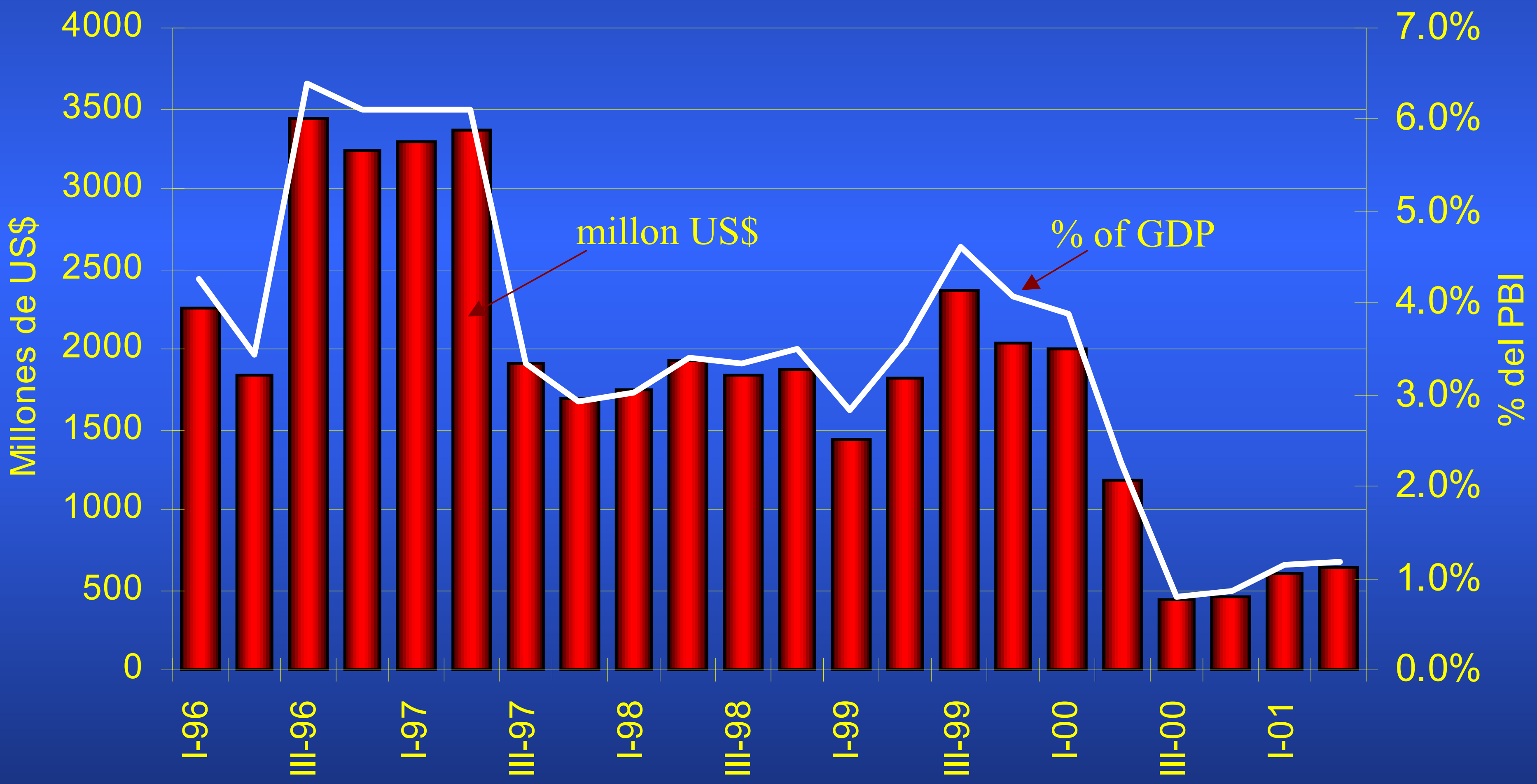
Capital Flows

(4 quarters, millions of US dollars and % of GDP)



Foreign Direct Investment

(Last 4 quarters, millon US$ and % of GDP)



SUDDEN STOP

Country/Episode	*Reversal of K. Inflows (% of GDP)*
Argentina 1982-83	20
Ecuador 1995-96	19
Mexico, 1981-83	12
Korea 1996-97	11
Thailand 1996-97	26
Turkey 1993-94	10

Current Account Adjustment (as % of GDP)

Country Group	T-1	T crisis	T+1	Change
EMs	-4.46	-3.97	-1.39	3.47
Advanced	-2.84	-3.06	-2.10	0.74
Difference	-1.62	-0.91	0.71	2.73**

Note: ** denotes significance at the five percent level.
Source: The World Bank and Calvo-Reinhart “Fixing for your Life,” April 2000.

Globalization Hazard: Key Factors

- External Institutional Factors:
  - change in US regulations
  - launching of Brady Bonds and the development of the EM Bond Market
- Domestic Institutional Factors:
  - Fear of Floating
  - Poor Credibility
- Informational Factors:
  - Liquidity shocks and lack of international lender of last resort.

POLICY ISSUES

Public Sector Involvement

- Rationale: Low Probability Events, LPEs, and transaction costs.
- Implication: ex post transfers if LPE may be optimal
- Problems:
  - some transfers are international in nature.
  - if government has high debt, it cannot be an effective Lender of Last Resort. *Weak Governments*, generate *peso problems* and induce high interest rates.

INTERVENTION BY WEAK GOVERNMENTS WORSENS THE CRISIS UNLESS IT IS SUPPORTED BY IFIs.

A CLEAR EXAMPLE IS CENTRAL BANK INTERVENTION, WHICH HAS LED TO LARGE LOSSES OF INTERNATIONAL RESERVES

Exchange Rates under Weak Government

- Macro balance-sheet shocks ought to be avoided
- Thus, monetary system must be in line with the type of indexation that prevails in financial transactions, e.g.,
  - fixed rates in highly dollarized systems
  - Inflation Targeting if interest is indexed to CPI.

What If Crisis Hits?

- Private Sector Involvement, PSI,
  - if creditors' coordination is not possible, PSI is not effective for solvency problems
  - however, PSI + IFIs guarantees, or other credible guarantee, would be effective.
- Emerging Market Fund, EMF
  - helps to prevent **contagion**
  - less likely to lead to Moral Hazard than CCL and Meltzer's proposal.

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