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

Source: WEO, IMF, May 2001
Foreign Direct Investment

Source: WEO, IMF, May 2001
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

<table>
<thead>
<tr>
<th>Country/Episode</th>
<th>Reversal of K. Inflows (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina 1982-83</td>
<td>20</td>
</tr>
<tr>
<td>Ecuador 1995-96</td>
<td>19</td>
</tr>
<tr>
<td>Mexico, 1981-83</td>
<td>12</td>
</tr>
<tr>
<td>Korea 1996-97</td>
<td>11</td>
</tr>
<tr>
<td>Thailand 1996-97</td>
<td>26</td>
</tr>
<tr>
<td>Turkey 1993-94</td>
<td>10</td>
</tr>
</tbody>
</table>
## Current Account Adjustment (as % of GDP)

<table>
<thead>
<tr>
<th>Country Group</th>
<th>T-1</th>
<th>T crisis</th>
<th>T+1</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EMs</strong></td>
<td>-4.46</td>
<td>-3.97</td>
<td>-1.39</td>
<td>3.47</td>
</tr>
<tr>
<td><strong>Advanced</strong></td>
<td>-2.84</td>
<td>-3.06</td>
<td>-2.10</td>
<td>0.74</td>
</tr>
<tr>
<td><strong>Difference</strong></td>
<td>-1.62</td>
<td>-0.91</td>
<td>0.71</td>
<td>2.73**</td>
</tr>
</tbody>
</table>

Note: ** denotes significance at the five percent level.
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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