Research on emerging market countries represents a rapidly growing share of the agenda of the NBER program in International Finance and Macroeconomics. While members of the program continue to work on many other topics as well, this survey of the last four years will concentrate on work relevant to emerging markets. This research included a big project directed by Martin Feldstein and me, on Financial Crises in Emerging Markets. This project in turn included eight meetings on crises in specific countries -- the Mexican crisis of 1994, the East Asian crises during 1997-98, through Argentina’s crash in 2001 -- along with many other conferences. It produced eight books.

Institutions

Economists’ interest in those countries that have become integrated into world financial markets over the last few decades can be seen as part of a larger increase in attention paid to developing countries in general. The field of development economics has recently risen from the lower part of economists’ “pecking order” of prestige, toward a more glamorous location on the totem pole. Why some poor countries have been able to join the ranks of the rich, and others have stayed behind, is one of the most important questions of our time. Research on the deepest determinants of growth now emphasizes three big influences: openness to trade, tropical geography, and, especially, the quality of a country’s institutions, such as protection of property rights, efficacy of the legal system, and absence of corruption. Financial markets institutions, such as protection of shareholder rights receive particular emphasis. Shang-Jin Wei and co-authors document that corruption in a country makes foreign investors skittish.

Research by members of the IFM program tends most often to deal specifically with macroeconomic questions such as the choice of monetary and exchange rate policy, or a country’s decision whether to open up its financial markets to international capital flows. But Acemoglu, Johnson, Robinson, and Thaicharoen argue that macroeconomic policies in developing countries are often the manifestation of deeper institutions and interest groups. For example, an IMF requirement that a country devalue in order to raise the domestic price of export commodities may simply be offset by some other policy to restore the preceding political equilibrium. Some of the more interesting findings discussed in this review concern the interaction of countries’ institutions with these macroeconomic decisions.

Exchange rate regimes

One major question addressed by IFM members is a country’s choice of currency regime: a fixed exchange rate, a floating exchange rate, or a regime with an intermediate degree of flexibility (such as a target zone). The debate is an old one, but it acquired some new aspects in the late 1990s. One new development was the decision of some countries to abandon their independent currency for a device to fix its value firmly, such
as a currency board or official dollarization. Sebastian Edwards and Igal Magendzo find that dollarization and currency unions have delivered lower inflation, as promised, but with higher income volatility. One of the arguments for a firm fix was that it would force domestic institutions to evolve in a favorable way, and would help prevent the chronic monetization of fiscal deficits that had undone so many previous attempts at macroeconomic stabilization. Argentina’s currency board, for example, appeared to work very well during most of the decade. It was believed that this “convertibility plan” had encouraged reforms that by the late 1990s had turned Argentina’s banking system into one of the best among all emerging markets. But when Argentina’s crisis crested in 2001, neither the supposedly deep pockets of foreign parents that had been allowed local bank subsidiaries, nor any of the country’s other innovative reforms, were able to protect its banking system. This outcome cannot but have had a dampening effect on the earlier enthusiasm for currency boards.

Another new argument for monetary union has been influential empirical findings by Andy Rose and co-authors that the boost to bilateral trade has been significant, and larger (as large as a threefold increase) than had been previously assumed. While many others have advanced critiques of the Rose research, the basic finding has withstood perturbations and replications remarkably well, even though the estimated magnitudes are sometimes smaller. Some developing countries seeking enhanced regional integration may now try to follow Europe’s lead.

There are plenty of arguments in favor of floating currencies as well, and most of the victims of the last eight years of crises in emerging markets have responded by increasing exchange rate flexibility. One advantage that is beginning to receive renewed emphasis is that floaters are partially insulated against fluctuations in the world market for their exports.

A relatively new realization is that attempts to categorize countries’ choice of regime (into fixed, floating, and intermediate) in practice differ from the official categorization. Countries that say they are floating, for example, often in reality are not. Indeed neat categorization may not be possible at all. That Argentina was in the end forced to abandon its currency board, in 2001, also dramatizes the lesson that the choice of exchange rate regime is not as permanent or deep as had previously been thought. The choice of exchange rate regime is more likely endogenous with respect to institutions, rather than the other way around. The “corners hypothesis” -- that countries are, or should be, moving away the intermediate regimes, in favor of either the hard peg corner or the floating corner – became fashionable in the late 1990s; but it is now another possible casualty of the realization that no regime choice is in reality permanent, and that investors know that.

If a country decides against setting a target for the exchange rate, that still leaves the question of what alternative target or targets will guide monetary policy instead, as Lars Svensson has emphasized. Setting a target for the money supply is no longer in fashion, for good reason. One popular alternative is inflation targeting. Another is the Taylor rule. An open area for research is whether and how such rules can be adapted for the special circumstances facing emerging market countries.
Opening up financial markets

Another major question that a country must decide is whether to liberalize financially, particularly the extent to which it wants to remove controls on international capital movements. It is part of the larger debate over globalization. Do the advantages of open financial markets outweigh the disadvantages? There are many potential gains from international trade in financial assets, by analogy with the gains from international trade in goods. Peter Henry and Anusha Chari, for example, have shown that when countries open up their stock markets the cost of capital facing domestic firms falls (stock prices rise), with a positive effect on their investment and on economic growth. Controls designed to moderate capital inflows may thus raise the cost of capital and slow growth. They may particularly impact small firms.

Nevertheless, financial liberalization has often been implicated in the crises experienced by emerging markets over the last ten years. Certainly a country that does not borrow from abroad in the first place cannot have an international debt crisis. Perhaps, then, there is a role for capital controls. Dani Rodrik finds evidence that Malaysia’s decision to impose controls on outflows in 1998 helped it weather the Asia crisis. But Simon Johnson and Todd Mitton find that Malaysian capital controls mainly worked to provide a screen behind which politically favored firms could be supported. Research has more often been sympathetic to a specific kind of capital control: Chile-style penalties on short-term capital inflows, under the theory that they tilt the composition in favor of more stable long-term inflows.

A blanket indictment (or vindication) of international capital flows would be too simplistic. Some of the most interesting research examines under what circumstances financial liberalization is more likely to be good or bad for economic performance. One claim is that financial opening lowers volatility and raises growth only for rich countries, and is more likely to lead to market crashes in lower-income countries. A second claim is that capital account liberalization raises growth only in the absence of macroeconomic imbalances, such as overly expansionary monetary and fiscal policy. A third important finding is that institutions such as shareholder protection and accounting standards determine whether liberalization leads to development of the financial sector, and in turn to long run growth. A related finding is that corruption tilts the composition of capital inflows toward the form of banking flows (and away from Foreign Direct Investment), and toward dollar denomination (vs. denomination in domestic currency), both of which have been associated with crises. The implication is that financial liberalization can help if institutions are strong and other fundamentals are favorable, but can hurt if they are not.

All these findings are consistent with the conventional lesson regarding the sequencing of reforms: that countries will do better in the development process if they postpone opening of the capital account until after other institutional reforms. Of course, the observable positive correlation between the opening of capital markets and growth could be attributable to reverse causation – rich countries liberalize as a result of having developed, not as a cause – but Edison et al conclude from their own tests that this is not the case.
**Origins of currency crises**

What are the sources of crises in emerging markets, and why have they so often led to sharp recessions? Levels of debt that would not necessarily seem high by the standards of rich countries get some “debt-intolerant” developing countries into repeated trouble.\(^{40}\) When a poor country runs into difficulty, the international financial community demands that it cut its deficits, while rich countries tend to elicit the opposite response. What explains the key difference between global investors’ treatment of developing countries, versus developed countries?\(^{41}\) The traditional explanation is macroeconomic fundamentals.\(^{42}\) But this does not seem to fit for some of the recent crises, inspiring models with multiple equilibria (a country may get shifted to a crisis equilibrium even if its leaders do not initiate unsound economic policies).\(^{43}\) There are also models that feature herding\(^ {44}\), bubbles\(^ {45}\), and a particular role for mutual funds\(^ {46}\) and other large investors in speculative attacks.\(^ {47}\)

One prime culprit is the inability of developing countries to borrow internationally in terms of their own currency, termed by Eichengreen and Hausmann the problem of “original sin.”\(^ {48}\) Firms or banks that incur liabilities in dollars or other foreign currencies while their revenues are primarily in domestic currency face the problem of currency mismatch; this in turn can lead to insolvency and contraction when the domestic currency devalues sharply.\(^ {49}\) These balance sheet effects are at the center of many analyses.\(^ {50}\)

Banks, in particular, have been implicated in most crises, usually due to the acute problem of moral hazard created by the prospect of government bailouts.\(^ {51}\) Foreign Direct Investment is a less risky source of capital inflow than loans.\(^ {52}\) The same is true of equity flows.\(^ {53}\)

IFM researchers have devoted a lot of attention to the observed correlation of financial volatility across emerging markets, including what is often called contagion of crises\(^ {54}\). Jessica Tjornhom Donohue and Kenneth Froot note the high persistence of portfolio flows of institutional investors across emerging markets and individual investment funds, and decompose the source of this persistence into a cross-country, cross-fund component, which might arise from contagion, versus other components.\(^ {55}\) Graciela Kaminsky and Carmen Reinhart find that when contagion spreads across continents, it passes through major financial centers along the way.\(^ {56}\) But Kristin Forbes finds that contagion spreads along the lines of trade linkages.\(^ {57}\)

**Response to crises**

Once a country is hit by an abrupt cut-off in foreign willingness to lend – a “sudden stop”\(^ {58}\) – it hardly matters what was the cause. The urgent question becomes the appropriate policy response. Often the loss in foreign financing must be taken as given. Thus there must be a reduction of the same magnitude in the previous trade deficit. How can the adjustment be accomplished? Is a sharp increase in interest rates [to reduce overall spending, and increase the attractiveness of much-needed capital
inflow] to be preferred to a sharp devaluation [to switch expenditure away from the consumption of internationally traded goods, and to switch production toward them]?

Many victims of crises in the late 1990s had to experience both. Regardless what mix of policies has been chosen, recessions have been severe. Further questions of interest include: Is the output loss smaller if the country goes to the International Monetary Fund? What are the impacts of IMF and World Bank programs on income distribution? What are “best practices” for domestic financial restructuring?

Even though many currency crises over the last ten years have often led to output losses larger than expected, one encouraging pattern has been that inflation has usually responded to devaluations much less than expected. The traditional view had been that countries, especially small countries, experience rapid pass-through of exchange rate changes into import prices, and thence to the general price level. But this assumption appears to have become less valid. Burstein, Eichenbaum and Rebelo find that the price indices are kept down by substitution away from imports toward cheaper local substitutes. The pass-through debate has recently focused on a comparison of the alternatives of producers pricing in their own currency vs. in local currency, in the context of the new open economy macroeconomic models, where all decisions are based on optimizing behavior. Charles Engel has questioned the validity of the assumption of producer-currency pricing, and in turn questioned the validity of the role of the exchange rate as an effective mechanism of trade balance adjustment. But Maurice Obstfeld argues that even if consumers face prices that are unchanged in local currency, devaluations spur adjustment through other channels, such as firms’ decision to switch their source of imported inputs.

The question whether to adjust to a current account deficit by devaluing or by other means takes the necessity of adjustment as given, as a consequence of the sudden stop in foreign financing. A final major set of questions for inquiry elects not to take as given the magnitude of the loss in foreign financing. Alternatives include default, debt-reduction, forgiveness, rescue packages by the IMF, and arm-twisting of private investors to continue their exposure (called Private Sector Involvement). Here policy decisions made by the U.S. government and other members of the G-7 are central. On the one hand, the IMF moderates the severity of crises by acting as an international sort of lender of last resort, even though its resources are proportionately far smaller than the traditional domestic lender of last resort. On the other hand, IMF bailouts are often criticized for making the problems worse in the long run, due to moral hazard. IMF plans to institute a Sovereign Debt Restructuring Mechanism -- a sort of international bankruptcy court -- have recently succumbed to strong resistance. Instead, some prominent emerging market countries have recently added “Collective Action Clauses” to their bond contracts, in part inspired by Barry Eichengreen’s arguments that this is a realistic way to accomplish private sector involvement without the worst of the moral hazard problems of IMF bailouts.

Debt-reduction seemed to help many developing countries put the 1980s debt crisis behind them (the Brady Plan of 1989). Can it do the same today? A recurrent puzzle is why more countries don’t default on their debts. Andy Rose finds that bilateral debt reschedulings lead to losses of trade along corresponding bilateral lines estimated at 8% a year for 15 years, from which he infers that lost trade is the motivation debtors have to avoid such defaults. Michael Dooley has provocatively suggested that
deep recessions, which most observers consider an undesirable effect of crises, are there for a reason: the system’s way of assuring investors that debtors have an incentive to avoid default. Despite the usual view that the global system has a long-run interest in punishing defaults, recent developments in Iraq have led Michael Kremer to propose an exception: if it can be impartially ascertained what ruler (like Saddam Hussein) constitutes an oppressive tyrant, then the international community could encourage successor regimes to default on the debt that their countries inherit; such a system would work to reduce the credit access of future tyrants.

Endnotes

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