Lecture 18: Crises in Emerging Markets

Continuing from Lecture 12

- Boom-bust cycle of inflows & outflows
- Sudden stops
  - Managing capital outflows
  - Speculative attacks
- Contagion
- IMF Programs
- Car crash analogy
- Appendix: The most recent cycle
  - The 2003-08 boom
  - Who got hit by the Global Financial Crisis of 2008-09?
  - Who got hit by the “taper tantrum” of 2013?
Cycle in capital flows to emerging markets

Cycle prophesied by Joseph in Egypt:
7 fat years followed by 7 lean years.
Cycle in capital flows to emerging markets

• 1<sup>st</sup> developing country lending boom (“recycling petro dollars”): 1975-1981
  – Ended in international debt crisis 1982
  – Lean years (“Lost Decade”): 1982-1989

• 2<sup>nd</sup> lending boom (“emerging markets”): 1990-96
  – Ended in East Asia crisis 1997
  – Lean years: 1997-2003

• 3<sup>rd</sup> boom (incl. China & India this time): 2003-2008
  – Ended in 2008 GFC – at least for the moment.
  – Crisis of the Euro periphery: 2010-12
  – Will Fed increase in interest rates hit EMs? 2013-15
The 3rd wave of flows to EMs was interrupted by the Global Financial Crisis in late 2008.
The role of US monetary policy

- Low US real interest rates contributed to EM flows in late 1970s, early 1990s & early 2000s. (BP=0 shifts down.)

- The Volcker tightening of 1980-82 precipitated the international debt crisis of 1982. (BP=0 shifts up.)

- The Fed tightening of 1994 helped precipitate the Mexican peso crisis of that year.
  - as predicted by Calvo, Leiderman & Reinhart (1993).

- Will it happen again, as $i^* \uparrow$?
  - 2013 taper tantrum.
  - 2015?
After Fed “taper talk” in May 2013, capital flows to Emerging Markets reversed again.

Say a country finds itself with a deficit, e.g., because rise in $i^*$ shifted BP line up

Alternative Ways to Manage Capital Outflows

A. Allow money to flow out (can cause recession, & banking failures)

B. Sterilized intervention (can be difficult, and only prolongs the problem)

C. Allow currency to depreciate (inflationary)

D. Reimpose capital controls (probably not very effective)
Speculative attack:
The capital outflow accelerates so rapidly that the central bank is forced to devalue by its rapid loss of all reserves.

3 generations of models of speculative attacks, with 3 kinds of causes:

* Overly expansionary macro policy -- Krugman (1979)...
* Excessive speculation: “Multiple equilibria” -- Obstfeld (1994)...
* Domestic financial structure: moral hazard (“crony capitalism”) -- Dooley (2000)...

What is the difference between a speculative attack and a regular balance of payments crisis?

- In Hemingway’s *The Sun Also Rises*, a character is asked, "How did you go bankrupt?" His response: "Gradually ... then suddenly."
Traditional balance of payments problem: Reserves gradually run down to zero, at which point CB is forced to devalue.
Sudden exhaustion of Mexico’s reserves in 1994 Peso Crisis

Modern currency crises: reserves almost fall off a cliff.

An irrational stampede?

Not necessarily. Rational expectations theory says $S$ can’t jump unless there is news; at the date of the attack the remaining $Res$ is (just barely) enough to satisfy the increase in FX demand without a jump in the price $S$. 

(See graph for Mexico, 1994.)
Contagion  In August 1998, contagion from the Russian devaluation/default jumped oceans.

Source: Mathew McBrady (2002)
Categories/Causes of Contagion

• “Monsoonal effects” (Masson, 1999): Common external shocks
  • E.g., US interest rates ↑ or “Risk off”;
  • World recession;
  • $ commodity prices ↓.

• “Spillover effects”
  • Trade linkages;
  • Competitive devaluations (“currency war”);
  • Investment linkages.

• Pure contagion
  • Stampede;
  • Wake-up call: Investor perceptions of, e.g., Asian model or odds of bailouts;
  • Illiquidity in financial markets.
Major IMF Country-Programs

3 components

- Country reforms
  (macro policy & perhaps structural)

- Financing from IMF
  (& sometimes G-7, now G-20)

- Private Sector Involvement
  (so public money doesn’t go to bail out investors).
THE CAR CRASH ANALOGY

Sudden stops:
“It’s not the speed that kills, it’s the sudden stops”

– Dornbusch

Superhighways:
Modern financial markets get you where you want to go fast, but accidents are bigger, and so more care is required.

– Merton
Is it the road or the driver? Even when many countries have accidents in the same stretch of road (Stiglitz), their own policies are also important determinants; it’s not determined just by the system.

– Summers

Contagion is also a contributor to multi-car pile-ups.
Moral hazard -- G7/IMF bailouts that reduce the impact of a given crisis, in the LR undermine the incentive for investors and borrowers to be careful. Like air bags and ambulances.

But to claim that moral hazard means we should abolish the IMF would be like saying drivers would be safer with a spike in the center of the steering wheel column. – Mussa

Correlation does not imply causation: That the IMF (doctors) are often found at the scene of fatal accidents (crises) does not mean that they cause them.
**Optimal sequence:** A highway off-ramp should not dump high-speed traffic into the center of a village before streets are paved, intersections regulated, and pedestrians taught not to walk in the streets. So a country with a primitive domestic financial system should not necessarily be opened to the full force of international capital flows before domestic reforms & prudential regulation.

=> There may be a role for controls on capital inflow (speed bumps & posted limits). -- Masood Ahmed

**Reaction time:** How the driver reacts in the short interval between appearance of the hazard and the moment of impact (speculative attack) influences the outcome. Adjust, rather than procrastinating (by using up reserves and switching to short-term $ debt) – J Frankel
Appendix:
More on crises in emerging markets

• Cycles of capital flows to developing countries
• Are big current account deficits dangerous?
• How did the 2003-08 boom differ from past cycles?
• Who got hit by the Global Financial Crisis of 2008-09?
• Who got hit by the “taper tantrum” of 2013?
Cycles of capital flows to developing countries:

**1975-81** -- Recycling of petrodollars, via bank loans, to LDCs

1982 -- Mexico unable to service its debt on schedule =>
Start of *international debt crisis* worldwide.

**1982-89** -- The “lost decade” in Latin America

**1990-96** -- New record capital flows to *emerging markets* globally

1994, Dec. -- Mexican *peso crisis*

**1997-2002** -- EM currency crises:

- 1997 July -- Thailand forced to devalue =>
  starting *East Asia* crisis (Indonesia, Malaysia, Korea...)

- 1998, August -- Russia devalues & defaults on much of its debt.
  => Contagion to Brazil; LTCM crisis in US.

- 2001, Feb. -- Turkey abandons exchange rate target

- 2002, Jan. -- Argentina ends “convertibility plan” (currency board)

**2003-**

- New capital flows into developing countries, incl. *China, India*..
  - interrupted by GFC 2008-09
  & “taper tantrum” 2013.
Are big current account deficits dangerous?

Neoclassical theory: if a country has low capital/labor ratio or transitory negative shock, large CAD can be optimal.

In practice: Developing countries with big CADs often get into trouble. Traditional rule of thumb: “CAD > approx. 4% GDP” is a danger signal.

“Lawson Fallacy” -- CAD not dangerous if government budget is balanced, so borrowing goes to finance private sector, rather than BD.

Amendment after Mexico crisis of 1994 – CAD not dangerous if $BD=0$ and $S$ is high, so the borrowing goes to finance private $I$, rather than $BD$ or $C$.

Amendment after East Asia crisis of 1997 – CAD not dangerous if $BD=0$, $S$ is high, and $I$ is well-allocated, so the borrowing goes to finance high-return $I$, rather than $BD$ or $C$ or empty beach-front condos (Thailand) & unneeded steel companies (Korea).

In taper tantrum of 2013 – CA deficit countries vulnerable ("Fragile Five").
How did the 2003-08 boom differ from past cycles?

- BRICs China & India were big recipients of private capital inflows.
- Most EM countries did not use inflows to finance CA deficits,
  - but rather to pile up international reserves.
- Most middle-income countries no longer fix their exchange rate.
- Perhaps as a consequence, many borrowed less in $,
  - more in their own currency.
  - And more FDI.
- => less vulnerability to a sudden stop.
- In global crisis of 2008, some developing countries were relatively “decoupled” from the shock
- The big exception was much of Central & Eastern Europe:
  - Ex ante: Lots of borrowing denominated in € (& even Swiss Francs)
The Global Financial Crisis was quickly transmitted to emerging market currencies in September 2008.
Spreads had been low, but rose again in Sept. 2008, esp. in Central/Eastern Europe.
Best and Worst Performing Countries in Global Financial Crisis -- F&S (2012), Appendix 4

GDP Change, Q2 2008 to Q2 2009

64 countries in sample
The variables that show up as the strongest predictors of country crises are: (i) reserves and (ii) currency overvaluation.

% of studies where leading indicator was found to be statistically significant
(total studies = 83, covering 1950s-2009)

Source: Frankel & Saravelos (2012)
Global investor interest in government debt resumed for some Emerging Markets in 2010
Countries with worse current accounts were hit by greater currency depreciation after “taper tantrum” of May 2013.

Countries with higher inflation rates, also, were hit by greater currency depreciation after May 2013.