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Some Reflections on the Current Global Crisis from a Developing Countries Perspective

ROBERTO FRENKEL AND MARTIN RAPETTI

FRIEDRICH EBERT STIFTUNG

1. Introduction

The current global crisis originated in the US financial system. Since it is the center of a network that interlinks national financial systems of almost all countries in the world, the crisis spread out very quickly. The fall in asset prices, the liquidity contraction and the increased uncertainty in financial markets gradually started to affect economic activity. The resulting contraction in aggregate demand spread out all over the world through international trade channels, reinforcing the contractive forces. According to the IMF the world economy would experience in 2009 the biggest contraction in the last 60 years. Most analysts agree that the world economy is going through the worst crisis since the Great Depression.

Modern mainstream macroeconomic theory failed to predict the current financial and economic crisis. This failure had an impact in academic circles. Several influential figures in the mainstream have recently manifested their dissatisfaction with it. Among the skeptics we find Robert Solow, George Ackerloff and Robert Shiller, Willem Buiter, Paul Krugman and Dani Rodrik[1]. One seemingly shared view among both heterodox and mainstream critics is that contemporary mainstream macroeconomics has systematically neglected important knowledge and insights that were widely known by previous generations of economists.

A key insight of Structuralist and Institutional economics is that economic behavior does not necessarily replicate in the same way in all countries. This article focuses on two important differences between developed and developing countries regarding financial crises. Section 2 argues that the factors that trigger the booming phase that precedes a financial crisis are different in developed and developing countries. For instance, the conditions that have led to financial crises in developing countries are found in the implementation of macroeconomic policies, which set the incentives that ended up generating the boom-and-bust cycles. On the contrary, in developed countries the elements that trigger the booming phase have endogenously developed inside the domestic financial system. Section 3 deals with the difference between developed and developing countries regarding governments' ability to conduct stabilization policy once financial crises unfold. The main argument here is that since in developing countries agents typically have a preference for foreign assets, governments have less room to conduct expansive monetary and fiscal policies than in developed countries. Based on these two differences, at the end of both sections we present proposals to ameliorate the effects of the current global crisis on developing countries.

2. Financial crises in developed and in developing countries

Since the sub-prime crisis unfolded, there have been signs of reaction against the mainstream economic paradigm and an incipient reevaluation of those scholars who have addressed the issue of financial crises as a central topic. Among them, Minsky's work seemed to have caught significant attention and has therefore been brought back from an almost total intellectual exile. The conditions that caused and then helped to develop the current financial crisis in the US correspond very neatly to Minsky's model of financial crises. In his model[2], crises are always preceded by a period of economic and financial

1 See Solow, R. 2008. Comments on "Modern Macroeconomics in Practice: How Theory is Shaping Policy" by V. V. Chari and Patrick J. Kehoe. Journal of Economic Perspectives. vol. 22, Number 1, Winter 2008, 243–249., Akerlof, G., and Shiller, R. 2009. Animal Spirits, Princeton University Press., Buiter, W. 2009. The unfortunate uselessness of most 'state of the art' academic monetary economics, Willem Buiter's Maverecon blog, http://blogs.ft.com/maverecon/2009/03/the-unfortunate-uselessness-of-most-state-of-the-art-academic-monetary-economics/ , Krugman, P. 2009. A dark age of macroeconomics, Paul Krugman's blog, http://krugman.blogs.nytimes.com/2009/01/27/a-dark-age-of-macroeconomics-wonkish/., Rodrik, D. 2009. The sorry state of (macro)economics, Dani Rodrik's blog, http://rodrik.typepad.com/dani_rodriks_weblog/2009/03/the-sorry-state-of-macroeconomics.html.

2 Minsky's work on financial crises and their relation with the macroeconomy is vast. His critique to the neoclassical digestion of Keynes' contributions and the relevance of finance in Keynes' framework can be found in Minsky, H. 1975. John Maynard Keynes, New York: Columbia University Press., a synthetic presentation of his model of financial crises in Minsky, H. 1977. "A Theory of Systemic Fragility." In Financial Crises: Institutions and Markets in a Fragile Environment, edited by Edward I. Altman and Arnold W. Sametz. New York: John Wiley and Sons. and the most polished and mature exposition of his thought in Minsky, H. 1986. Stabilizing an Unstable Economy, New Haven: Yale University Press. Kindleberger, C. 1978. Manias, Panics, and Crashes: A History of Financial Crisis, New York: John Wiley and Sons. provides an exhaustive historical account of financial crises analyzed under Minsky's framework.

boom. During the booming phase, there are widespread optimistic expectations about the future. Confidence increases and risk perception reduces. In this environment, economic agents take risky positions and the system becomes increasingly fragile. At some point, some event calls agents' attention about the high degree of exposure to risk in the system. A phase of distress begins. The emerging perception of higher risk makes most agents switch their portfolios in favor of safer and liquid assets. The excess demand for liquidity and low-risk assets ends up pricking the bubble, which results in a massive loss of wealth. In this contractive phase, pessimistic expectations are dominant. Negative feedback effects are the rule in the contractive process, just as positive ones prevailed during the booming phase. The deflationary developments in the financial markets turn most agents either liquidity-constrained or bankrupt, affecting in either case their spending decisions negatively. Private consumption falls and investment collapses. What started as a contraction in the financial sector has now spread out to the whole economy. The financial crisis leads to a systemic economic crisis.

Since the 1970s, Minskyan boom-and-bust-cycles have been observed in a number of crises, such as in Argentina and Chile (1979), Mexico and Argentina (1995), East Asia (1997/98), Russia (1998), Brazil (1999), Turkey and Argentina (2001). In all these episodes, crises were preceded by periods of boom, where financial intermediation and asset price bubbles developed in a context of increasing risk-taking behavior. The analysis of all these episodes shows that crises did not result from unsustainable fiscal policies, negative external shocks or moral hazard behavior due to explicit or implicit government guarantees. They arose, instead, from the increasing financial fragility resulting from the combination of a higher appetite for risk by the private sector and a lax public regulation of financial markets during the booming phase[3].

The current financial crisis in the US and those in emerging market economies are similar in their dynamics. There is, however, a key difference between the crises in emerging market economies and the subprime crisis in the US (and other crises in developed countries). The difference lies on the factors that kick off the booming phase of the Minskyan cycle. In the case of emerging market economies, the financial bubbles and innovations that emerge and develop in the booming phase of the cycle have resulted from the implementation of new macroeconomic policy rules, including the opening of the capital account, which provide a profitable environment for financial arbitrage between domestic and foreign assets.

This conclusion emerges from the comparative analysis of the mentioned crises episodes in emerging market economies[4]. The analysis shows that all these cases share the following features. First, the conditions that trigger the booming phase are generated by relatively drastic changes in the macroeconomic policies. These typically combine the liberalization of the domestic financial market and the capital account with some rule of nominal exchange rate predetermination (e.g. pegs or active crawling pegs). The implementation of new macroeconomic rules can be understood as an exogenous shock on the financial system, which rapidly sets the incentives for arbitrage that kick off the boom. Second, the international capital movements have a key role in both the boom and the contraction in all cases. Finally, the regulation of domestic financial market is lax. This may happen either because the market was recently liberalized or because the expansion of financial activity during the boom is too large for the existent regulation capacity.

In sum, the trigger of the Minskyan cycle in the emerging market crises has an important *exogenous* component. Capital inflows and outflows then play a key role by multiplying the financial forces driving the cycle. On the other hand, the factors that trigger the cycle in the current financial crisis in the US (and other crises in developed countries) are essentially *endogenous*. The real estate bubble and the financial innovations that started with the securization of mortgages (and other debts) are the key ingredients of the booming phase of the Minskyan cycle in the US subprime crisis. There is an ongoing discussion regarding external stimulating factors, such as financial deregulation, the soft monetary policy and foreign capital inflows to the US. However, the comparison makes clear the difference between the exogenous nature of the elements triggering the booming phase in the emerging market crises and the endogenous dynamics of the cycle in the subprime crisis.

3 Taylor, L. 1998. Capital market crises: liberalisation, fixed exchange rates and market-driven destabilization, Cambridge Journal of Economics, vol. 22, 663-676.

4 Frenkel, R. 2003. Globalization and Financial Crises in Latin America, CEPAL Review, No 80.

Policy Options for Financial Regulation

The crises in both developed countries and emerging market economies have revealed the weaknesses and inadequacy of loosely regulated domestic financial systems. A comprehensive regulation is essential to avoid instability and crises. However, the prevention of financial instability and crises in emerging market economies involve elements that go beyond the regulation of domestic financial systems. In particular, the combination of macroeconomic policies together with the mode of integration to global financial markets plays a key role in the financial developments in emerging market economies. Preventing crises in emerging market economies thus requires not only the regulation of domestic financial systems, but also a consistent macroeconomic configuration, which includes the exchange rate policy and the policies related to the management of the balance of payments and the stock of foreign exchange reserves. Crises episodes in emerging market economies have shown, in particular, that countries should aim for 1) exchange rate systems that provide flexibility to the authorities and prevent speculation, 2) preventive measures to manage capital movements, and 3) policies that secure robust external accounts, including the accumulation of foreign exchange reserves and the preservation of competitive (or non-appreciated) real exchange rates.

The debate about financial regulations is open and there are many initiatives. A risk that developing countries face in this context is that reforms end up being discussed and shaped by developed countries and then imposed as international standards, as it has been happening so far. The active involvement of developing countries in the reformulation of financial regulations is an important issue that these countries should fight for, but even more important for them is to take advantage of the circumstances and push for their own agenda. This should incorporate at least three important lessons learnt from their own experiences of financial crises. First, the agenda should make explicit the autonomy of developing countries to apply capital account management techniques and to conduct macroeconomic policies with an important crisis-prevention component. Second, a global system of crises prevention should include international norms that help to smooth capital movements and also institutions and international mechanisms that help to compensate for private capital outflows. Third, developing countries should also pursue an international agreement on real exchange rate levels.[5] Developing countries can benefit from maintaining competitive real exchange rates in various ways. For the current discussion, it is relevant to stress that competitive exchange rates typically imply low dependence on foreign savings and lead to the accumulation of foreign exchange reserves. Both increase the external robustness of the economy and thus help to prevent sudden stops and financial crises.

3. So far: Policy responses in developed and in developing countries

Once the financial bubble generated during the 'subprime-mania' was pricked, governments of developed countries rapidly started to conduct stabilization policies. The initial reaction was to use monetary policy in the form of aggressive interest rate cuts. However, the sharp collapse of asset prices and the evidence that financial markets continued to be highly illiquid led central banks to conduct monetary policy using an 'unconventional' quantitative easing strategy. These drastic measures were sterile in their attempt to stop the declining trend in economic activity. Several governments of developed countries then decided that it was time to implement aggressive expansive fiscal policies. For instance, the Obama administration in the US launched a significant fiscal stimulus package of $787 billion in February 2009.

The policy response to the current crisis –in which a quantitative easing monetary policy and an aggressive fiscal policy play essential roles-found little support in modern mainstream macroeconomic theory.[6] Its inadequacy in this aspect has led to a revalorization of Keynesian economics and policy making. In particular, the insight that in contexts of depression and uncertainty, the expansion of public expenditure is a key instrument to fight the contractive effects of crises. The revalorization of Keynesian economics and policy making, however, has so far had a too narrow focus on the problematic of developed countries. Economists and policy makers should be aware that there are also significant differences between developed and developing coun-

5 For further discussion see Frenkel, R. and Rapetti, M. 2009. Economic Development and the International Financial System, in Ocampo, J. A. (ed), Financial Markets Regulation, Oxford University Press, forthcoming. .

6 See Woodford, M. 2003. Interest and Prices: Foundations of a Theory of Monetary Policy, Princeton University Press. for a comprehensive exposition.

tries regarding the use of macroeconomic policy to counteract the contractive effects of financial crises.

Leeway for counter-cyclical policy in highly industrialized countries

Financial crises imply wealth losses and financial disintermediation. Both factors lead to a contraction in consumption and investment and consequently to a fall in output and employment. In developed countries, agents take their deposits out from risky banks and switch their portfolios in favor of money and safe assets such as public bonds. The increase in the demand for money and public bonds implies that the government faces a greater supply of finance at a lower cost. In such a context, expansive fiscal policy can try to compensate for the contraction in private expenditure and thus revert or ameliorate the contractive trend in the economic activity.

In the current crisis in the US, the flight to quality has implied a greater demand for Treasury bonds, whose interest rates have fallen to a minimum. Given that the government issues debt in its own currency, the probability of default of these assets is very low. The value of bonds could depreciate rapidly if public debt is following an unsustainable path or excessive fiscal expansion ends up accelerating inflation. However, so far, none of these concerns seem to be affecting people's perception, since Treasury bonds keep operating as domestic and international store of value[7] .

The situation is similar in Europe and Japan. In the Euro area the outlook is somewhat more complex because there is a perception that public debts in some countries might be following an unsustainable path. Italian and Greek public bonds, for instance, stand at significant discount in relation to German bonds. However, it is hard to imagine that the European Union, at the risk of its dissolution, passively let Italy or Greece declare the default of their public debts or a unilateral restructuring. Even when the degrees of freedom of fiscal policy are certainly lower than in Germany, they are still much higher than in most developing countries.

Let us consider now the effects on the balance of payments. In the United States, Western Europe and Japan, the international repercussions via the contraction of trade affect more or less symmetrically both exports and imports. There is no clear asymmetry in the way quantities and prices of exports and imports are affected by the contraction of international trade. Therefore a global crisis does not tend to generate or accentuate any problem in the current account. On the other hand, there are no capital outflows and in the case of global crises it is even more likely to experience capital inflows, since their currencies are seen as international store of value.

In sum, financial crises in the above named countries typically induce a higher demand for money and public bonds, thus facilitating the financing of expansive fiscal packages. Furthermore, financial crises do not translate into balance of payment problems, neither through the current account nor through the capital account.

Pro-cyclical policy trap in developing countries

The effects of financial crises in developing countries are definitely more complex. In these countries crises also derive in wealth loss, credit contraction and a fall in aggregate demand with recessive effects on output and employment. But, contrarily to the case of developed countries, financial disintermediation typically generates a reduction in the demand for domestic currency and public bonds. The behavior is similar to that observed in financial crises in developed countries in the sense that agents run away from risky assets. The key difference is that in developing countries the set of risky assets includes public bonds and domestic corporate debts which are all subject to country risk. The flight to quality is thus funneled to the demand for money and public bonds from developed countries. In developing countries, financial crises lead to capital outflows.

The repercussions via the contraction of international trade also induce a worsening of the current account. In most of developing countries, a significant proportion of imports corresponds to manufactured goods, whereas exports have a relatively higher component of commodities. Since the price-elasticity of commodities is greater than that of manufacture goods, a contraction in international trade affects the terms of trade of developing countries negatively. The combination of capital outflows and current account deterioration leads to domestic currency depreciation and depreciation expectations. The latter induce in turn a further reduction in the

7 Dooley, M., Folkerts-Landau, D. and Garber, P. 2009. Bretton Woods II Still Defines the International Monetary System, Deutsche Bank Special Report, February.

demand for domestic currency and thus more capital outflows.

The portfolio shift of local and foreign agents against domestic assets reduces the supply of finance for governments. The resulting rise in the cost of finance together with the contraction of tax revenues due to the recessive tendencies forces the authorities to cut public expenditure. The result is just the opposite of the developed countries case: at the outset of a recession, governments in developing countries are forced to run contractive fiscal policies and raise the interest rates. This has traditionally been the conditionality demanded by the IMF in its financial assistance programs. The countries that agree to run austerity fiscal programs and raise the interest rates, and thus accentuate the recessive tendencies, do not generally do it because of an ideological bias. Most likely, governments consider the default of public and external debts as a worse outcome compared to a recession, and decide to follow contractive fiscal and monetary policies instead.

In sum, financial crises have two additional effects to those that are typically observed in developed countries. First, a financial crisis leads to a balance of payments adjustment as a result of a worsening of both the current account and the capital account. Second, the contraction in tax revenues and the rise in the cost of finance worsen the fiscal balance. The adjustment mechanism that is required to simultaneously balance the public and external accounts varies according to specific circumstances of the countries, but it typically implies some combination of exchange rate depreciation, interest rates hikes, and contractive fiscal policy. In any case, in developing countries the policy response to financial crises tends to add contractive impulses to the recessive trends in output and employment. In the most fragile cases, the financial crisis can easily end up in a balance of payment crisis and the default of public debt. In the most robust cases, the financial crisis leads to an increase in the fragility of public and external balances and a recession.

4. IMF capacities and policy options

As mentioned above, the IMF has traditionally promoted adjustment programs based on restrictive fiscal and monetary policies. However, there have recently been signs of change. The conditionality of the financial assistance programs that have been signed since the eruption of the subprime crisis is less restrictive and more specific than in the past.[8] The institution also promotes expansive fiscal policies for both developed and developing countries in order to counteract the recessive trends triggered by the global crisis[9]. Notwithstanding this positive change in its approach to crisis response, the IMF has paid little attention to the problem of how developing countries may finance those policies.

The tension between the need of expansive fiscal and monetary policies and the scarcity and high cost of finance available to service external and public debts exists in almost all developing countries. In this regard, the IMF finds itself trapped in a contradiction: on the one hand, it asserts the need of expansive fiscal and monetary policies to ameliorate the recessive trends in the global economy, but on the other hand, it has asked – although more moderately – for contractive policies in the recent stand-by programs that have been signed.

The proclamation of the IMF authorities in favor of the expansive fiscal policies is correct, but the nature of the crisis makes the likelihood of those policies being implemented in most developing countries very low. The contradiction derives from the lack of a coordinated international action, which would be required in order to finance expansive fiscal programs in many developing countries simultaneously. The IMF is constrained by both the amount of resources available and by the characteristics of the existing programs of financial assistance. These have been originally designed to deal with short-run balance of payment problems for one country or a small group of countries in a context of nor-

8 In late October 2008, the IMF informed about the creation of a new credit line of immediate disbursement – the Short Term Liquidity Facility – providing up to 500% of the countries quota at the IMF for a 3 months period, with the option of a double renewal. The only conditionality of this line was a favorable evaluation in a regular inform prepared by the IMF staff under the article IV. No country has required this line and on March 24, 2009 its discontinuation was announced. In replacement, on the same date the IMF announced the creation of a new line, the Flexible Credit Line. However, since September 2008, the IMF has signed stand-by programs with Belarus, El Salvador, Georgia, Hungary, Iceland, Latvia, Pakistan, Serbia, Seychelles, Ukraine and Romania. These countries are between those who have been suffering the effects of the global crises the most.

9 Blanchard, O., Spilimbergo, A. and Symansky, S. 2008. Fiscal Policy for the Crisis, IMF Staff Position Note, SPN/08/01.

mality in the rest of the economies and in the international financial market. When the emerging market economies crises during the 1990s became recurrent, many analysts had already pointed out that the amount of financial resources available and the nature of the programs were both insufficient and inadequate to deal with crises and contagion in an increasingly globalized world. But the current situation in the international financial market is completely novel, making evident the contradiction between what the authorities of the IMF say it should be done and what they can do given the available resources and instruments.

In order to do what the IMF says it should be done, something different is required: a significant injection of resources to finance fiscal stimulus packages in many developing countries that are facing external and public financing restrictions. Similarly to what is going on in the US, these programs should have two focuses. One direct beneficiary of the fiscal program should be the most vulnerable people. They should be reached through social security, health and education programs. These programs would help improve their living conditions but also would have higher multiplicative effects on employment and the economic activity. Second, the fiscal programs should aim to reinforce physical infrastructure, the protection of the environment and the development of technology. The motivation behind this second target is to use fiscal policy not only to stabilize the economy in the short-run, but also to contribute to the acceleration of the rate of growth in developing countries.

The credit facility lines should try to avoid short-term financing and their interest rates should be low. In contrast to the programs designed to overcome short-term disequilibria -which penalize the assisted country to avoid moral hazard behavior- these programs should be promoted in order to stimulate their request by developing countries. It is important to notice that the use of funds by individual countries has a positive external effect on the other countries members of the IMF. Developing countries could ask for interest rates similar to those faced by the US and other developed countries governments for the financing of their own fiscal programs.

The Special Drawing Rights (SDR) could be used for such purposes. The US government has systematically opposed the expansion of the stock of SDR since the early 1980s, arguing that it could lead to inflation. That argument is not valid in the current situation. The Federal Reserve of the US and other central banks of developed countries have not hesitated in expanding massively the supply of their currencies since the outset of the crisis, because they rightly identified that the threat is not inflation but deflation.

The IMF should issue a significant amount of SDR and offer a new credit line to the governments of developing countries to finance the above described expansive fiscal programs. The new credit line should be directed mainly to the governments and not the central banks.[10] The credit facility should not aim (exclusively) to reinforce the stock of foreign exchange reserves. In the current depressive context of developing countries, it is not liquidity what is mostly needed, but sources of aggregate demand. Besides, if the funds were used for to reinforce the stock of foreign exchange reserves, and not to serve the financial needs of governments, they would likely be used to finance private capital outflows.

The proposed use of the emission of SDR does not preclude other potential uses. Among them, it might be necessary to use the new credit line for the assistance and restructuring of domestic financial systems in those developing countries where is much needed, as in many Eastern European countries. Because of the large experience of financial crises in developing countries, the IMF has more expertise in running this kind of programs than in financing expansive fiscal programs. Expertise, however, will surely not be enough. The magnitude of resources that the IMF would need to deal with current global crisis is much higher than what it currently has.

5. Concluding remarks

There are signs that, due to the current global crisis, insights form Keynesian economic theory would have a comeback. Economists should not forget the lessons that have been learnt after three decades of several painful financial crises in developing countries. We emphasize two important lessons related to financial crises. First, preventing crises in emerging market economies requires not only the regulation of domestic financial systems, but also a consistent set of macroeconomic policies. This includes the exchange

[10] A first step in that direction has been made at the London Summit on April 2, 2009. The G20 agreed to treble resources available to the IMF to 750 bn USD, to support new SDR allocation of 250 bn USD and to use additional resources from agreed IMF gold sales for concessional finance for the poorest countries.

rate policy and the policies related to the management of the balance of payments and the stock of foreign exchange reserves. Besides, a global system of crises prevention should include international norms that help to smooth capital movements and also institutions and international mechanisms that help to compensate for private capital outflows. Second, financial crises in developing countries tend to worsen both the balance of payments and the fiscal balance. The traditional adjustment policies tend to exacerbate the recessive trends in output and employment. Policy makers need to address this problem and enable governments in developing countries to push counter cyclical policies in order to reverse the crisis related economic downturn.

The G-20 is has begun the discussion of a new a financial architecture aimed to ease the development of boom-and-bust cycles in financial markets. Developed countries will probably give prominence to the regulation of financial activities and markets. Developing countries should support initiatives in that direction, but they should also push for an agenda that help them to deal with the problems discussed here.

The authors:
Roberto Frenkel is a Principal Research Associate at CEDES and Professor at the University of Buenos Aires.
Martin Rapetti is a Research Associate at CEDES and PhD candidate at the University of Massachusetts, Amherst.

Friedrich-Ebert-Stiftung
Department for Development Policy
- Dialogue on Globalization –
Hiroshimastrasse 28
10785 Berlin
Germany
Tel.: ++49 (0)30 26935-7404
Fax: ++49 (0)30 26935-9246
Mail: globalization@fes.de
www.fes-globalization.org