

During the last two decades, many middle-income countries (MICs) have liberalized their financial markets. Such a policy has led to a greater incidence of crises, largely because liberalization has been associated with risky international bank flows and lending booms. As a result, several commentators have criticized financial liberalization, and have proposed that authorities intervene in financial markets to attain a slow-and-steady growth path.

Before following this policy recommendation restricting open and free capital markets, it is important to note the startling fact that over the last two decades, most of the fastest-growing countries of the developing world have experienced lending booms and busts. Countries in which credit growth has been smooth have, by contrast, exhibited the lowest growth rates.

It would thus appear that factors that contribute to financial fragility have also been a source of growth, even if they have led to greater fluctuations and even occasional crises. Therefore, to better understand economic fluctuations in MICs, it is necessary to determine what are the underlying distortions that affect financial markets in MICs, how their interaction makes fluctuations in MICs so large in magnitude relative to high-income countries (HICs), and why the forces that lead to greater growth also generate financial fragility. Such a conceptual framework allows one to make normative statements regarding liberalization policies.

The aim of this book is to address these points. Our approach to this task is divided into three parts. First, we characterize key macroeconomic regularities observed across MICs: we document the long-run link between liberalization, growth, and financial crises; we characterize patterns and comovements of key macroeconomic variables along the typical boom-bust cycle; we show that these comovements are observed more generally in tranquil times—that is, without conditioning on the occurrence of crises. We show that credit markets play a key role in such large fluctuations, not only in the boom-bust episodes that surround crises, but also in the strong “credit channel” observed during tranquil times—that is, in the strong response of the gross domestic product (GDP) and other macroeconomic variables to interest rate shocks.

In the second part of this book, we present a theoretical framework that explains how credit market imperfections prevalent in MICs can account for these empirical patterns. We then use this framework to address the normative question of whether financial liberalization is a good idea even if it leads to financial fragility. Lastly, in the third part, we provide microevidence on the credit market imperfections that drive the results of the theoretical framework. The synthesis presented in this book is based on joint papers we have written together and with Lorenza Martínez, Romain Rancière, and Martin Schneider.

In comparison with HICs, the economic fluctuations experienced by MICs are of a much larger magnitude, and resemble more the Roaring Twenties and the Great Depression than the postwar business cycles of the Group of Seven (G7) countries. There is no evidence that MICs have systematically experienced more frequent and more severe exogenous shocks than HICs. What, then, can explain the severity of the boom-bust cycles, the strong credit channel, and the positive link between long-run growth and the incidence of crisis across MICs?

At the heart of the amplification mechanism is a sharp asymmetry between the tradables (T) sector and the more bank-dependent nontradables (N) sector. Each of the sectors reacts differently to shocks, with real exchange rate fluctuations playing a crucial role in amplification. While the N sector typically grows faster than the T sector during booms, it falls harder during crises and takes much longer to recover. Furthermore, this sectoral asymmetry is also observed during tranquil times: credit varies strongly with the N-to-T output ratio and movements in credit are strongly correlated with those of the real exchange rate—the relative price between N and T goods.

While this sectoral asymmetry has received little attention in the literature, it is key to understanding the patterns in MIC data. Throughout this book, the sharp responses of the N-to-T output ratio observed in the data will be derived from a sectoral asymmetry in financing opportunities prevalent in MICs: while T-sector firms tend to be large and have access to world capital markets, most N-sector firms are small and bank dependent. N-sector firms face severe contract enforceability problems and their lenders enjoy systemic bailout guarantees—that is, in the event of a crisis, lenders are bailed out at the taxpayers' expense.

We will argue that the mechanism that distinguishes the cyclic experience of MICs from that of HICs is based on the sectoral asymmetry in financing opportunities, differences in the degree of contract enforceability and the interaction of this imperfection with systemic bailout guarantees.

In a nutshell, the mechanism works as follows. Contract enforcement problems together with bailout guarantees generate stringent financing constraints and lead borrowers to take on credit risk, often in the form of currency mismatch. That is, debts are denominated in foreign currency, while the income streams that service those debts are in domestic currency. In such an economy, there is a strong balance sheet effect—that is, shocks to firms' cash flow

have a strong effect on the economy. Moreover, fluctuation in the real exchange rate—that is, the relative price of T goods in terms of N goods—play a key amplifying role.

This “risky economy” exhibits a strong credit channel and can experience severe boom-bust cycles.

Despite the effects of financial fragility, in the long run, the risky economy outperforms the safe economy even in the presence of large crisis costs. This is because taking on credit risk permits constrained firms, most of which are in the N sector, to borrow and invest more during normal times, and because crises must be rare in order for agents to find it profitable to take on credit risk in the first place. As a result, the cumulative N-sector growth derived from higher investment in normal times outweighs the capital losses and the credit crunch experienced during a crisis. This translates into higher average GDP long-run growth because T-sector firms enjoy more abundant N-sector inputs.

Can one make the case for financial liberalization? Such a policy allows capital to flow more freely, and in addition it eliminates many regulatory barriers that prevent agents from taking on risk. This is why financial liberalization is typically followed by lending booms and then crises. Despite these crises, the lesson we should draw is not that financial liberalization is bad for growth and welfare. The analysis presented in this book shows that liberalization leads to higher growth because it eases financial constraints, but that this can occur only if agents take on credit risk. Therefore, high growth occurs at the cost of financial fragility.

A second, related point is that even though the entire economy must pay (through taxation) the crisis costs and the bailouts, everyone may gain from a risky credit path. Better access to capital benefits not only credit-constrained firms but the economy as a whole. For instance, an exporting firm that is not financially constrained will benefit from the fact that its suppliers have better financing opportunities and thus provide cheaper inputs. Hence, the whole economy can enjoy higher production efficiency.

An important policy lesson can be drawn from this discussion: Policies that try to reduce financial fragility may have the unintended consequence of choking off long-run growth. For example, a policy that blocks risky international bank flows, might starve many N-sector firms of external financing as foreign direct investment is directed mainly to the T sector. This, in turn, might generate bottlenecks for the T sector as N-sector inputs will stop growing.

We would like to stress that the arguments in this book depend on the existence of serious imperfections in the economic environment of MICs. We recognize that the first-best solution is to address the imperfections themselves—by improving contract enforcement and ending bailout guarantees. As a practical matter, however, it is not clear how to address either of these structural problems, and therefore we treat them as parameters of an MIC's economic environment. We do not intend to defend either corrupt practices—such as the granting of selective bailouts to politically connected agents—or unsustainable macroeconomic policies designed to delay unavoidable crises, but that lead to unnecessarily deep crises.

Models designed to study macroeconomic fluctuations in HICs are not directly applicable to MICs—in particular, because such models are not designed to account for the pronounced asymmetrical sectoral patterns, the sharp real exchange rate fluctuations, and the boom-bust cycles observed across MICs. Over the last decade, much research has been devoted to documenting the empirical regularities that distinguish MICs and developing models that account for such regularities.

The book is structured as follows. Chapter 2 presents a road map that connects the main points of the book. Chapter 3 examines the empirical link between liberalization, growth, and crises. Chapter 4 characterizes economic fluctuations in MICs. Chapter 5 contains the conceptual framework. Chapter 6 provides evidence on the credit market imperfections prevalent in MICs. And chapter 7 concludes with some policy implications.