Introduction to Part II

This part contains four chapters. Chapters 3 and 4 deal with the Tequila crisis, and chapter 5 presents my early reaction to the 1998 Russia crisis before I developed a formal apparatus (chapter 12) to check for logical consistency. Finally, chapter 6 discusses the recent 2001–2 Argentina crisis episode. The only major episode missing here is the 1997 South East Asia crisis.

In chapters 3, 4, and 5 the reader will find few references to topics like current account deficit, currency overvaluation, and fiscal deficit. Instead, the discussion there is focused on financial issues like insufficient backing of M2 and short-term foreign exchange liabilities with international reserves, and world capital markets that become dysfunctional after a liquidity squeeze. The explanation for the bias is that these papers were an attempt to show the importance of financial variables for either triggering a crisis or intensifying its effects. At the time, economists tended to ignore financial variables. This had a long history stemming from the many years that the private capital market was virtually closed to what we now call emerging market economies. Thus, for example, in order to assess whether a country held sufficient international reserves, the IMF used to look at the ratio of reserves to average monthly imports. This is a relevant statistic if international reserves are mostly held to ensure that imports will not collapse if the country faces a deterioration of its terms of trade, for example. The situation is quite different, however, if the government is also responsible for ensuring a working domestic banking system and securing the repayment of short-term debt when faced with adverse international financial conditions (e.g., a sudden stop in capital inflows). Under those circumstances, ratios like international reserves to M2 (or M2 plus short-term financial liabilities) are also relevant, particularly (although not exclusively) in a currency-peg regime.
The last chapter in this part (chapter 6) integrates the traditional variables into the analysis, but it does so while keeping a sharp focus on the financial sector. For example, chapter 6 shows that a large current account deficit (relative to the output of Tradables) could magnify the effects of a sudden stop if the economy exhibits high liability dollarization (i.e., foreign-exchange denominated debt). The reason is that typically during sudden stop episodes the current account deficit is pushed down to near zero. The latter implies that if the current account deficit is high, aggregate demand will exhibit a sharp contraction, lowering the relative price of nontradables relative to tradables (i.e., provoking a real depreciation of the currency). This may create serious financial difficulties in the nontradables sector if it is subject to high liability dollarization. Thus, the current account deficit comes back into the picture, but in a different role. Instead of being a signal of debt unsustainability, it returns as a signal of potential financial trouble. I personally believe that financial considerations are at the heart of recent crises. True, debt unsustainability cannot be dismissed out of hand, but if not for the intrusion of financial problems, debt unsustainability could be managed in a smooth and non-disastrous way—very far from the debacle scenarios that most recent crises have brought about.

Before closing this section, I would like to direct the reader’s attention to short chapter 5. It contains important insights that only recently have been subject to empirical analysis showing that a relevant transmission channel provoking EMs crises may have been the capital market itself (see Broner, Gelos, and Reinhart (2004) and Kaminsky and Reinhart [2004]). I sense that this is an area of research that is relatively underdeveloped and is very promising in terms of insights and global financial policy implications. For instance, from this perspective, in trying to anticipate the shock waves of a given country’s crisis, one should learn about the portfolio composition of the major holders of that country’s liabilities. This is so because the shock waves will reach countries whose liabilities are in the hands of the same investors. This view also has important implications for the design of a new global financial architecture. For example, the shock waves could be contained if there was a global Lender of Last Resort. Under this view, a Lender of Last Resort should be much more effective than sending Fund missions to all the countries involved in a global collision provoked by a dysfunctional capital market.
References
