Policy brief

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Maurice Obstfeld

International Growth Centre

Linking among Capital Flows, Trade and Growth in Developing Economies

In brief

- During 2007-2009, emerging market economies (EMEs) demonstrated resillience, which may refelct the widespread avoidance of leverage booms in EMEs during the 2000s, as well as more stable monetary and fiscal policies.
- Those EMEs that were worst hit by the financial crisis were those with the largest buildups of internal and external leverage.
- This study seeks to undesrstand the impact on EMEs of the global financial crisis, by contrasting the recent crisis with past EME financial crises, as well as with those that have hit advanced economies.
- The policy goal is to understand the macro development that typically precede crises.
- The 2007-2009 financial crisis had an uneven incidence throughout the world, with some EMEs faring much better than advanced economies.
- Crises in emerging and advanced economies originated from similar underlying factors: a buildup of domestic and external leverage in a context of explicit or implicit government guarantees to a liberalized financial sector.
- The data suggests other policy improvements that may have favoured EME resilience in the recent crisis, with relatively favourable fiscal performance in EMEs (declining public debts).

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Policy Motivation

This project seeks to understand the impact on emerging market economies (EMEs) of the 2007-09 global financial crisis, contrasting the recent crisis with past EME financial crises, as well as with crises that have hit the advanced economies (AEs) in recent past decades. We ask if there are substantive differences between the preludes and aftermaths of various types of crises in EMEs versus AEs, and if the most recent crisis, in which some emerging regions displayed considerable resilience, differs from past ones. We deploy a new panel regression-based methodology for isolating the salient behaviors of key macro variables before, during, and after three distinct (but sometimes related) types of crisis – sovereign default crises, banking crises, and currency crises. The policy goal is to understand the macro developments that typically precede crises, as well as to understand the economic factors that might aggravate or mitigate crisis severity. A particular focus is on the role of net and gross international financial flows and the current account balance as indicators of crisis vulnerability.

Policy Impact

The findings suggest that certain policy actions with respect to financial-sector growth and macroeconomic policy could reduce the likelihood and severity of financial crises. Policymakers should monitor carefully gross as well as net private financial flows and the current account balance.

Audience

Decision makers at national central banks, treasuries, and financial regulatory authorities, as well as staff of international financial institutions such as the IMF, regional development banks, and BIS.

Implications

The 2007-09 financial crisis had an uneven incidence throughout the world, with some EMEs faring much better than the AEs, where the crisis originated. Outside Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS), EMEs (on average) fared better than AEs. Latin America and the Caribbean was hit badly but tended to do better than the AEs.

Crises in emerging and advanced economies originated from similar underlying factors -- notably, a buildup of domestic and external leverage in a context of explicit or implicit government guarantees to a liberalized financial sector. Domestic credit growth preceding crises is a strong feature of the data. Even within the set of EMEs, countries in Central and Eastern Europe, which suffered more severe growth slowdowns in 2007-09, showed prior buildups of credit comparable to those of the AEs. These domestic credit booms were associated with foreign borrowing and the associated buildup of external leverage. In general, external leverage buildups appear directly to raise financial vulnerability, and large current account imbalances may well be generated by factors that raise financial vulnerability.

The data suggest other policy improvements that may have favored EME resilience in the recent crisis. Relatively favorable fiscal performance in EMEs (in the form of declining public debts) could have reduced pre-crisis vulnerability, while leaving fiscal space for a counter-cyclical policy response to the crisis.

Brief Summary of Research

"Outside Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS), EMEs (on average) fared better than AEs"

During the twentieth century, emerging and advanced economy financial crises bore some distinct qualitative similarities, although several features of emerging markets made their economies more volatile and crisis prone. For the advanced economies, the build-up and repercussions of the twenty-first century's first global crisis were similar to earlier crisis events. Emerging economies, however, displayed surprising resilience in 2007-2009. The relative output growth performance of the high-income AEs and regional groupings of EMEs is illustrated in the accompanying Figure 1. In light of evidence on past crises, this resilience may reflect the widespread avoidance in EMEs of leverage booms during the 2000s, as well as the pursuit of more stable monetary and fiscal policies. Within the EMEs, those that were worst hit by the crisis – in the CEE and CIS regions – were also those with the largest pre-crisis buildups of internal and external leverage. Greater financial globalization, as exhibited especially by AEs, may well enhance vulnerability to financial crises.

Implementation

The results of this research necessarily average over crisis types and country groupings. While that approach yields broad regularities, the application to policymaking in specific countries requires attention to the details of individual-country experiences, not just broad averages.

Further Readings

Pierre-Olivier Gourinchas and Maurice Obstfeld, "Stories of the Twentieth Century for the Twenty-First," American Economic Journal, January 2012.

International Monetary Fund. "How Did Emerging Markets Cope in the Crisis?" Mimeo, Strategy, Policy, and Review Department (June 2010).

M. Ayhan Kose and Eswar S. Prasad, Emerging markets: Resilience and growth amid global turmoil. Washington, DC: Brookings Institution Press, 2010.

Maurice Obstfeld, "Does the Current Account Still Matter?" American Economic Review Papers and Proceedings, May 2012, forthcoming.

Figure 1: Real GDP Relative to 2006 Levels

About the authors

Maurice Obstfeld is the Class of 1958 Professor of Economics and Director of the Center for International and Development Economic Research (CIDER). He joined Berkeley in 1989 as a professor, following appointments at Columbia (1979-1986) and the University of Pennsylvania (1986-1989). He was also a visiting professor at Harvard between 1989 and 1991. He received his Ph.D. from MIT in 1979. Professor Obstfeld serves as honorary advisor to the Bank of Japan's Institute of Monetary and Economic Studies. Among Professor Obstfeld's honors are the Carroll Round Keynote Lecture, Woodward Lecture, and Bernhard Harms Prize and Lecture in 2004. Professor Obstfeld is a Fellow of the Econometric Society and the American Academy of Arts and Sciences. He is active as a Research Fellow of CEPR, a Research Associate at NBER, and an International Research Fellow at the Kiel Institute of World Economics.

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

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For media or communications
enquiries, please contact
mail@theigc.org

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International Growth Centre,
London School of Economic
and Political Science,
Houghton Street,
London WC2A 2AE

International
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