

SUDDEN STOP AND RECOVERY ***Lessons and Policies***

Guillermo Calvo

Brunnen, Switzerland, June 19, 2006

Outline of Presentation

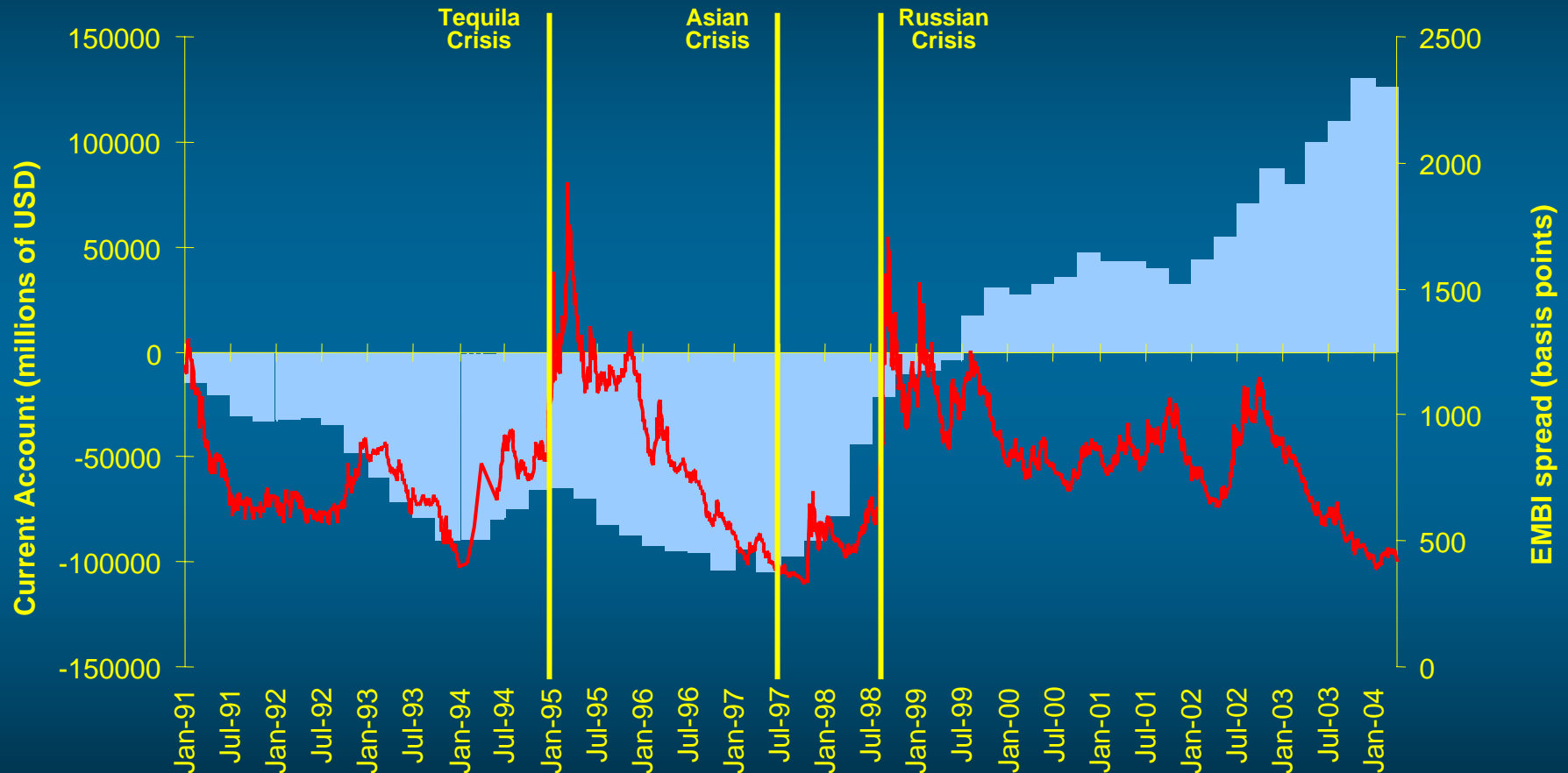
- Background
 - Accidents on the Highway
 - Sudden Stops
- Phoenix Miracles (Rising from the Ashes)
- Implications and Policy Issues

Background

Accidents on the Highway

External Financial Conditions for EMs

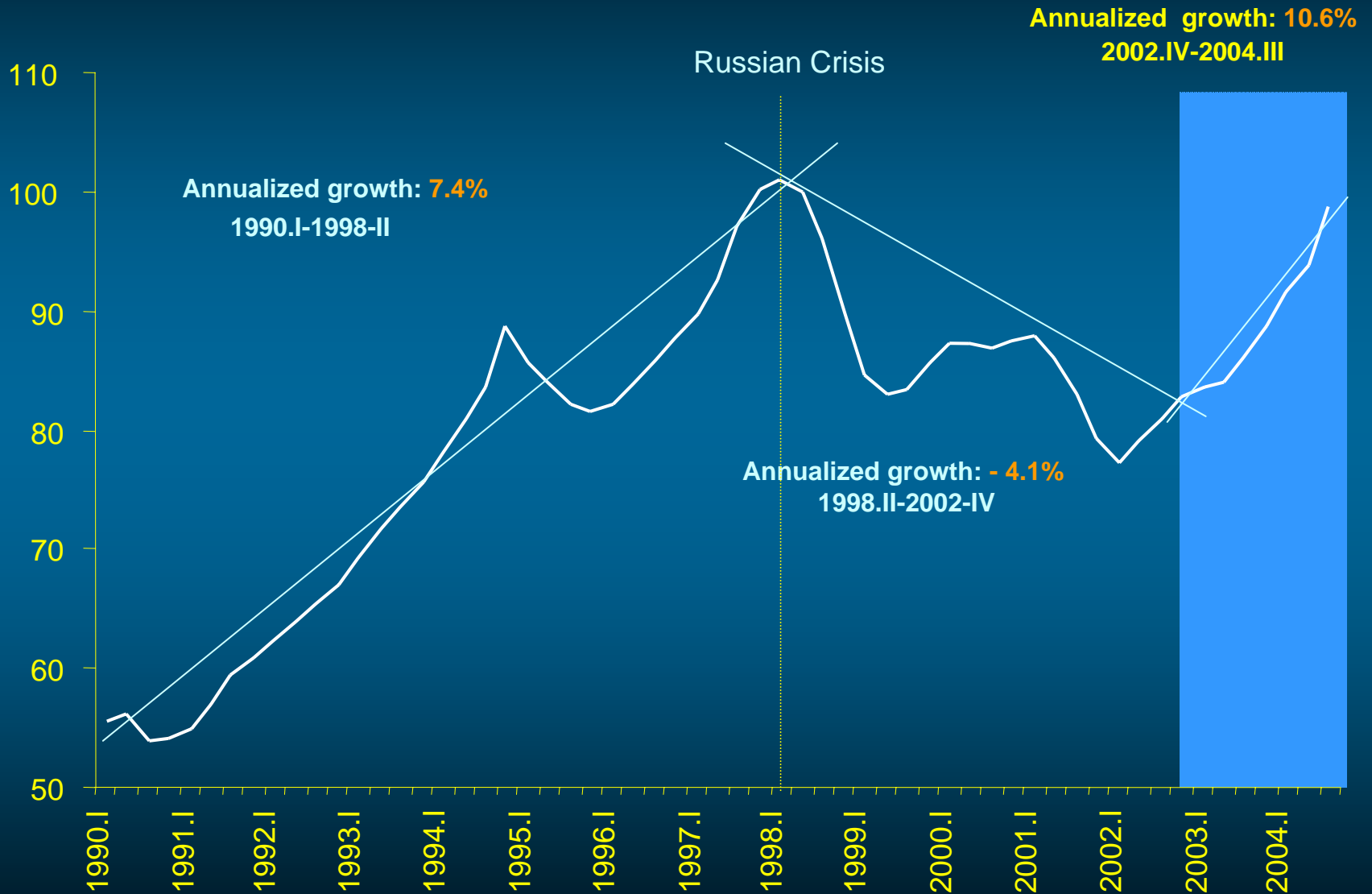
(EMBI sovereign spread & Current Account Balance in EMs, millions of USD, last four quarters)



Note: Includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Slovak Republic, South Africa, Thailand, Turkey and Venezuela.

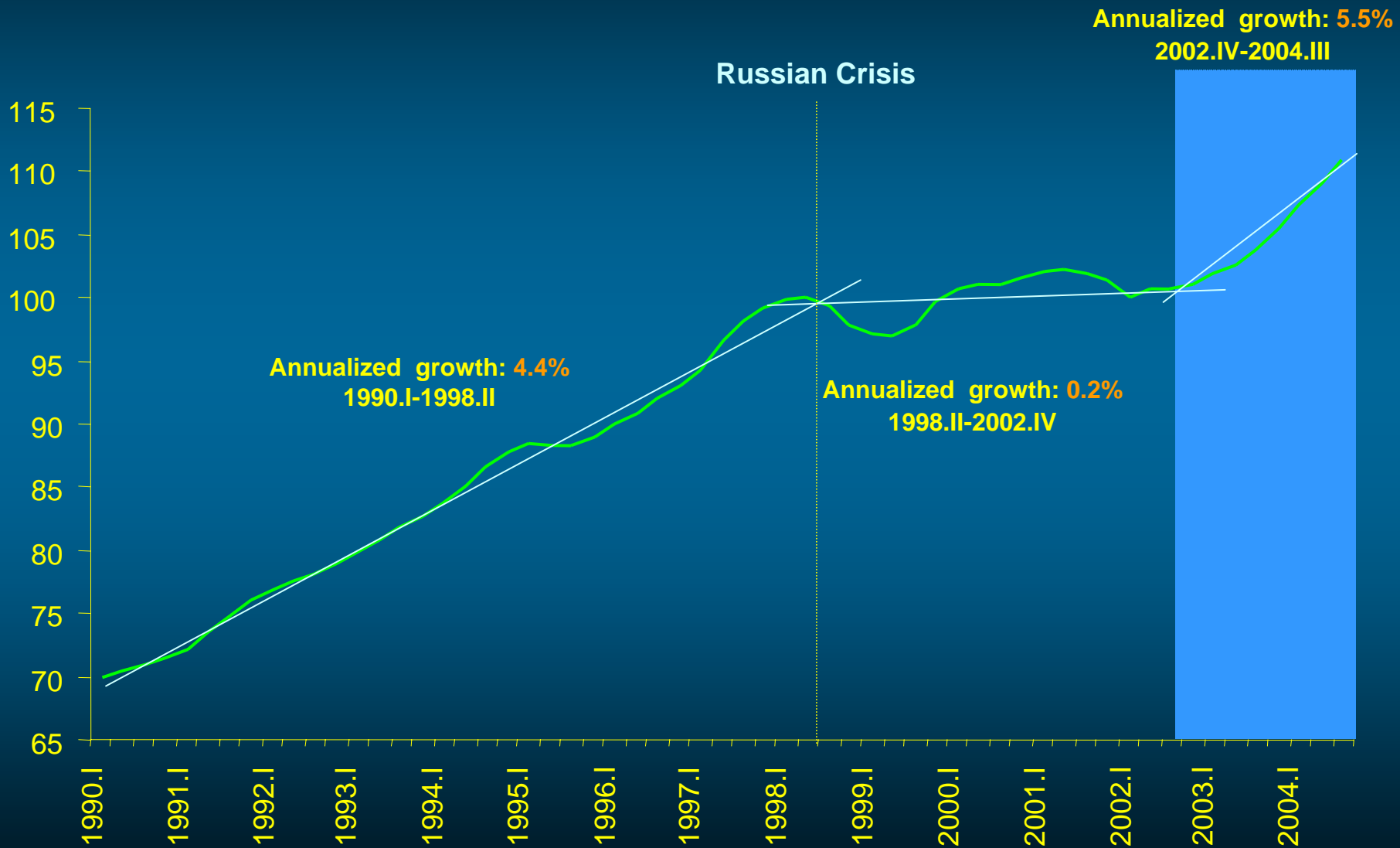
LAC 7: INVESTMENT

(LAC-7, s.a. Investment, 1998.II=100)



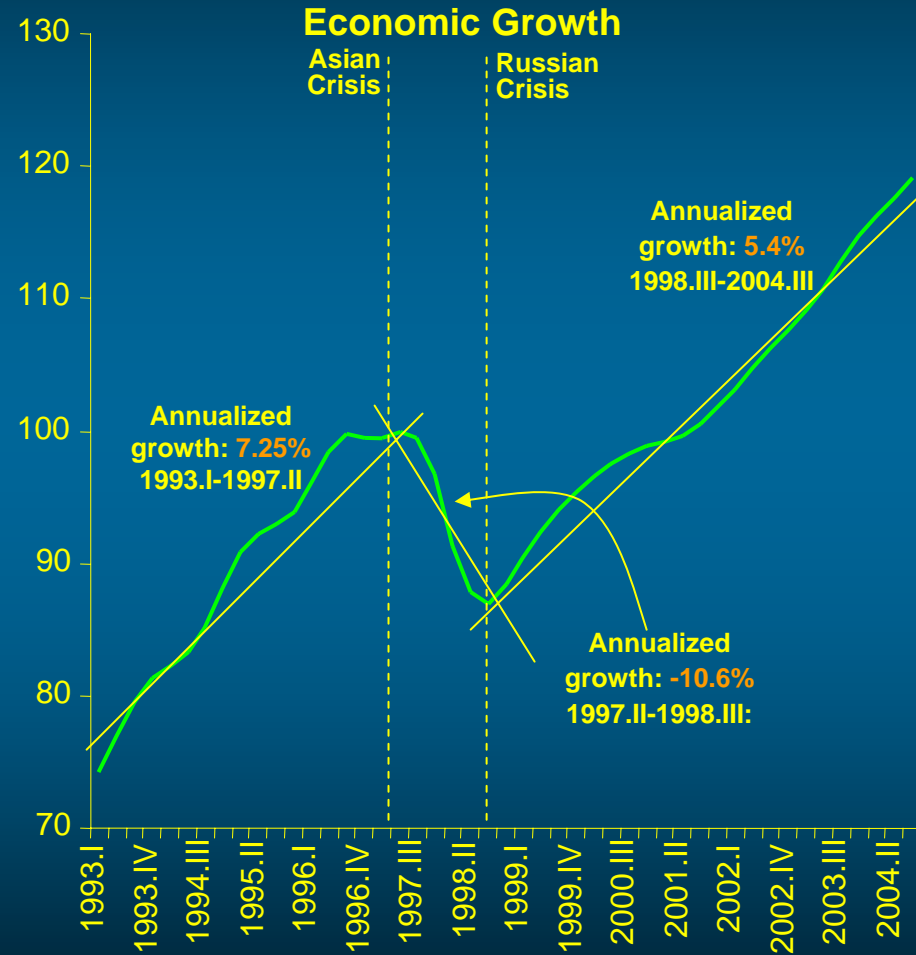
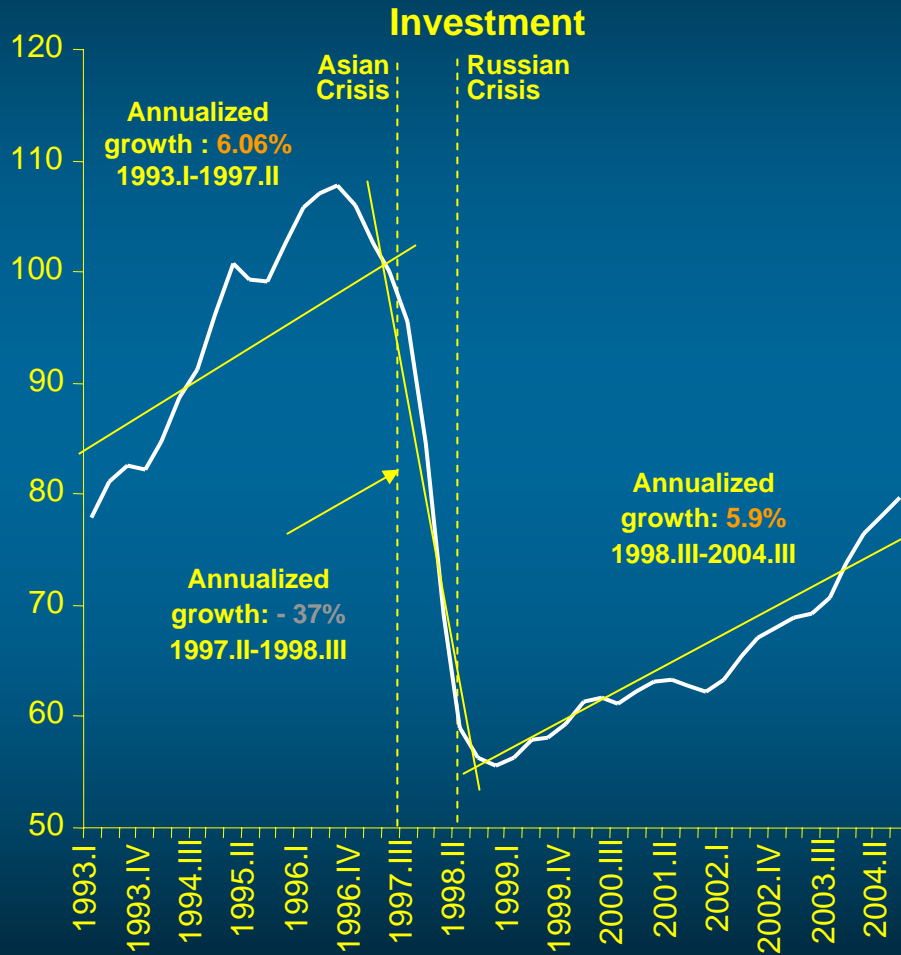
LAC 7: GROWTH

(LAC-7, s.a. GDP, 1998.II=100)



Emerging Asia: Investment and Economic Growth

(s.a. Investment and GDP, 1997.II=100)

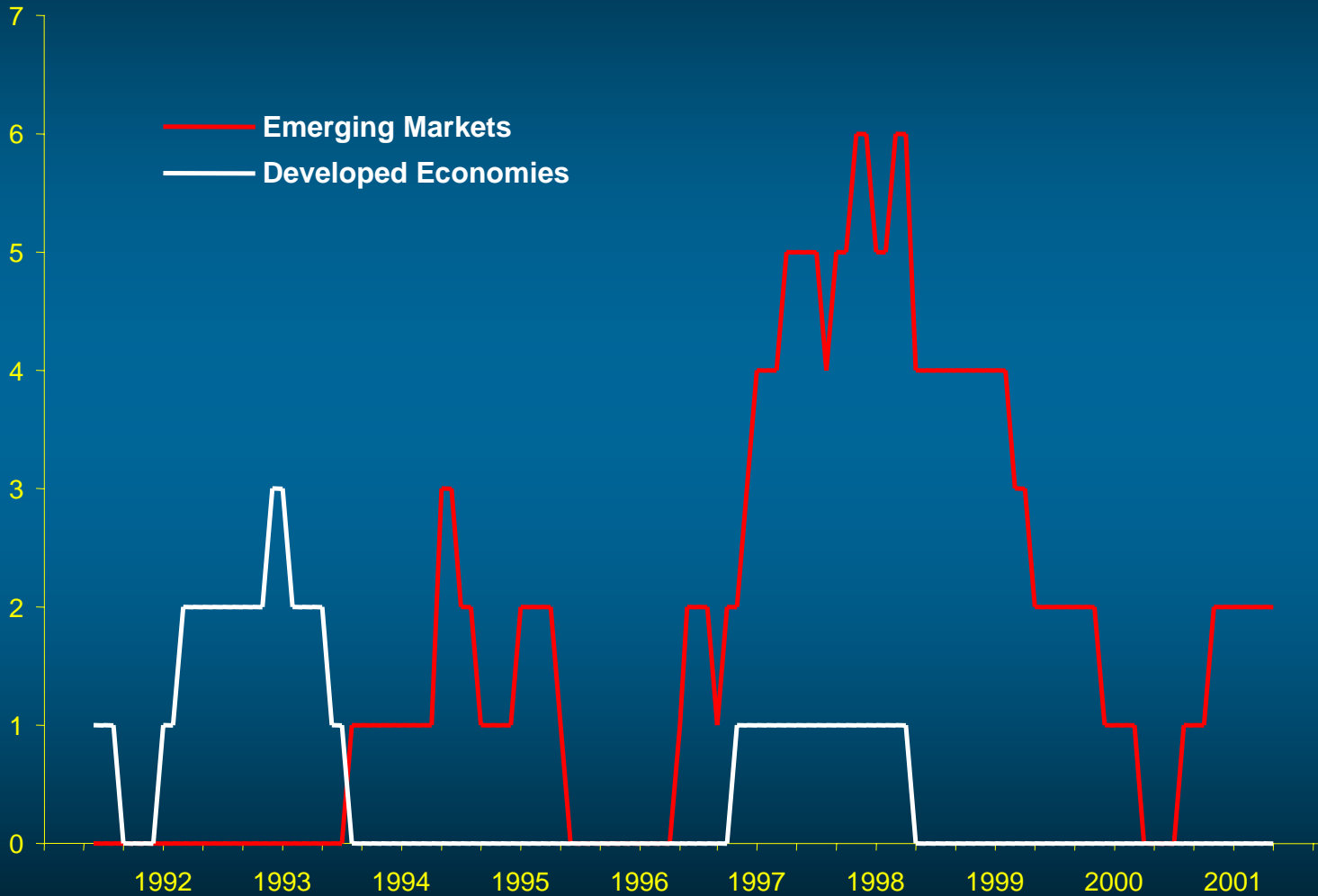


Includes Indonesia, Korea, Malaysia, Philippines and Thailand.

SUDDEN STOP

(of International Capital Inflows)

Number of Sudden Stops: The Bunching Effect



Sudden Stops and Large Depreciation

In % of total

	Emerging Markets	Developed Economies
Depreciations associated with Sudden Stop	63	17
Of which: First Sudden Stop, then depreciation	42	9
First depreciation, then Sudden Stop	21	9

Note: The total number of large devaluations is 19 in emerging markets and 23 in developed economies.

SS: Results of Earlier Empirical Tests

- The probability of a SS increases with
 - Current Account Deficit (as a share of Absorption of Tradables), CAD.
 - Domestic Liability Dollarization (as a share of GDP), DLD.
 - Interaction of CAD and DLD.
 - Inverse of TOT
- On the other hand, given the above, the probability of SS is not a function of
 - The foreign exchange system
 - Total debt
 - Fiscal deficit and other standard macro control variables.

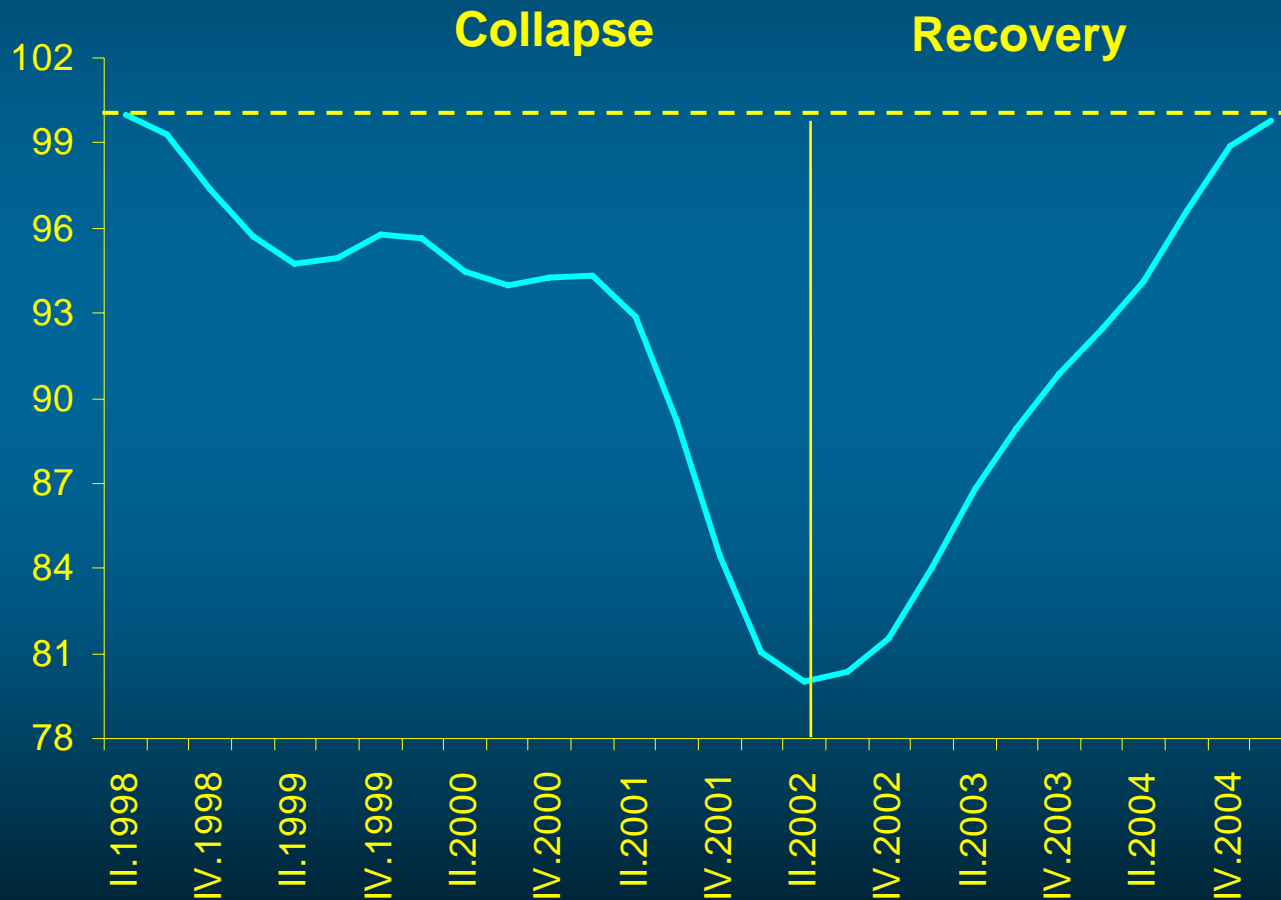
Bottom Line

- External factors play a key role in triggering financial crises in EMs.
- However, domestic vulnerabilities (e.g., DLD and small tradables sector) are also important in generating a full-fledged SS, and the depth of the resulting crisis.

Phoenix Miracles

Miracle in Argentina (?)

(s.a. GDP, II. 1998=100)

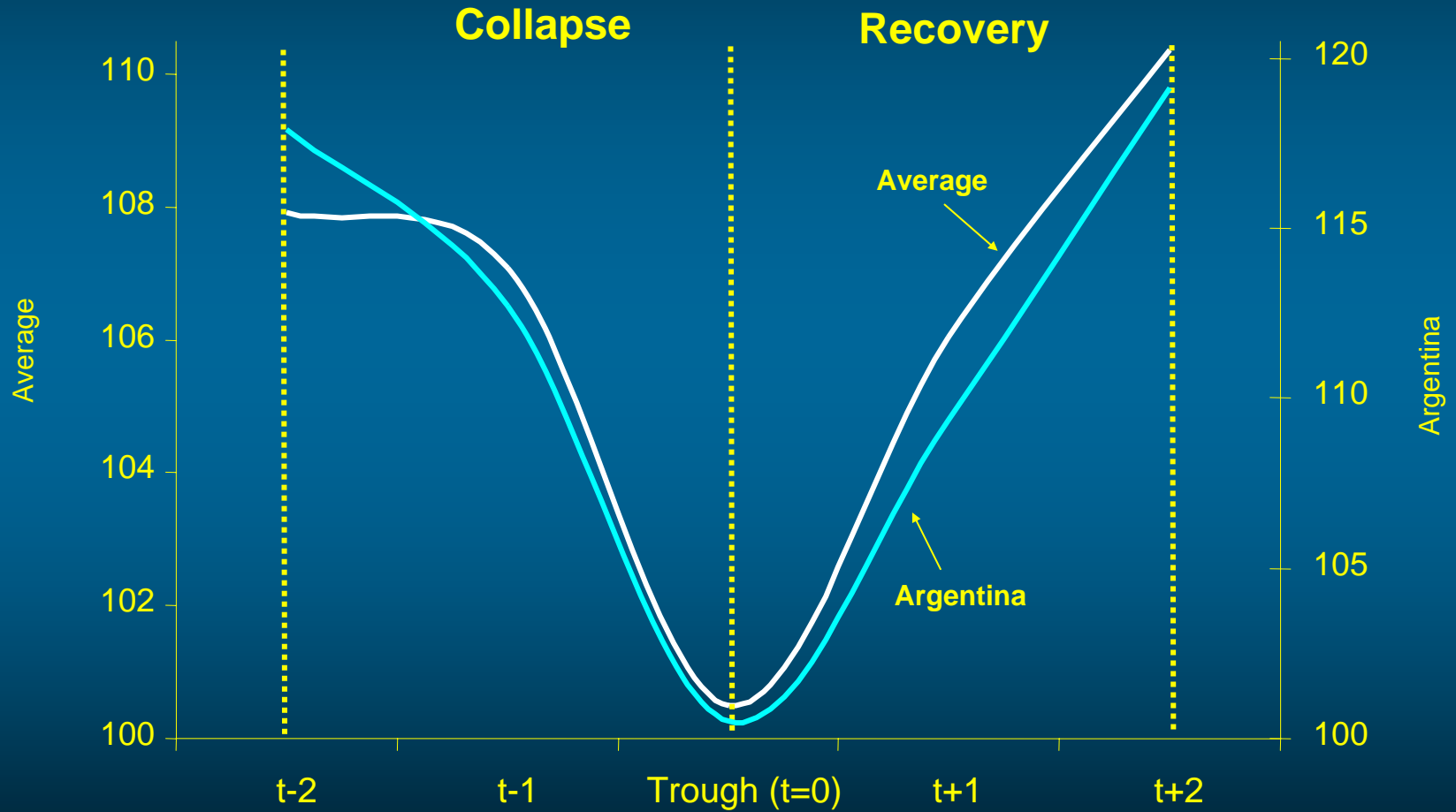


Anatomy of Post-Collapse Recoveries

- *Post-collapse recoveries are steep (V-shaped)*

The Behavior of Output

(Average 3S Episode, annual GDP)



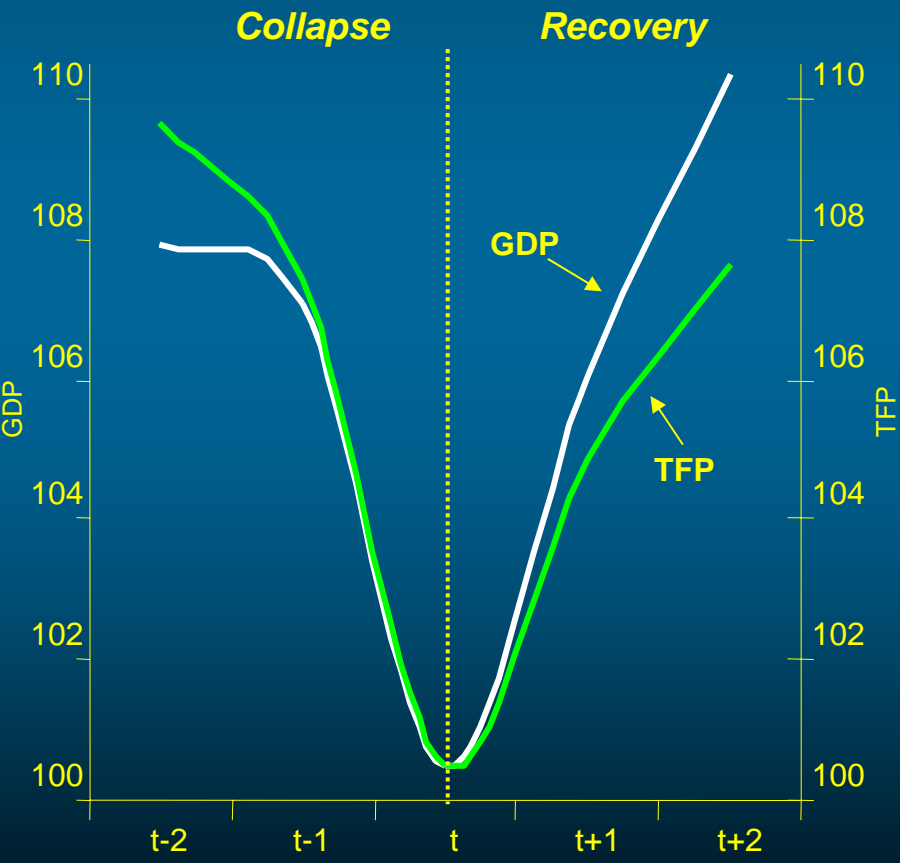
Anatomy of Post-Collapse Recoveries

- *Post-collapse recoveries are steep (V-shaped)*
- *Post-collapse recoveries in EMs display striking parallels with the US Great Depression...*
 - ❖ *Total Factor Productivity*

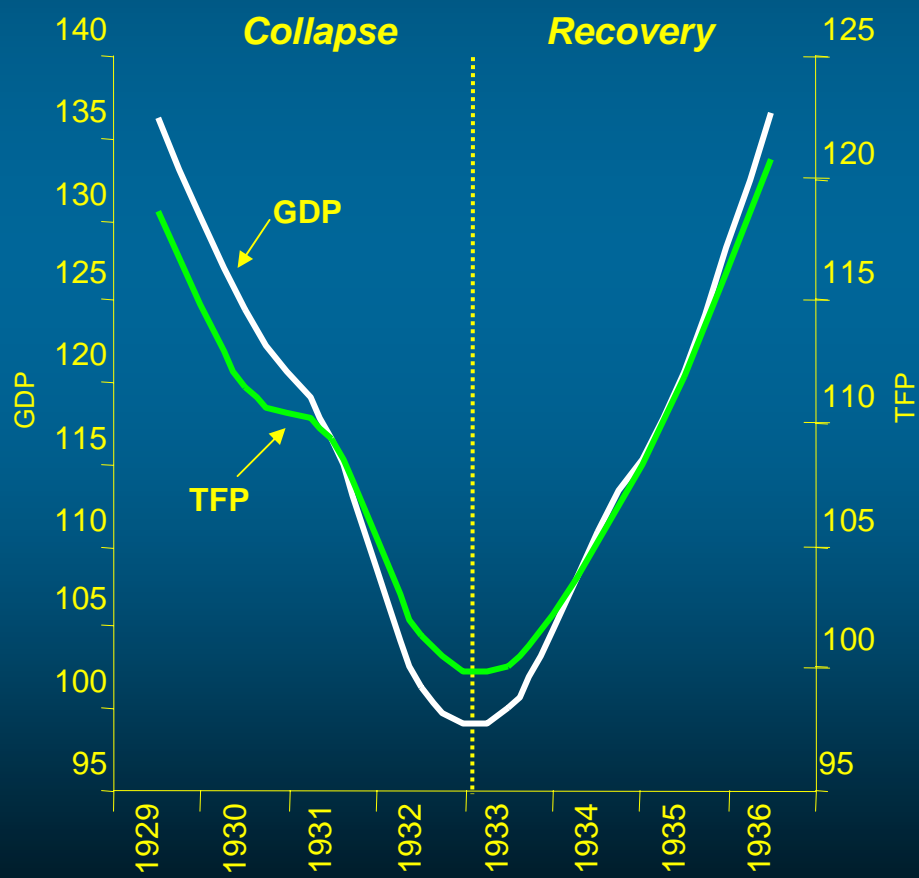
EM Collapses & the US Great Depression: Similarities

- Total Factor Productivity -

Collapses in EM Economies



US Great Depression



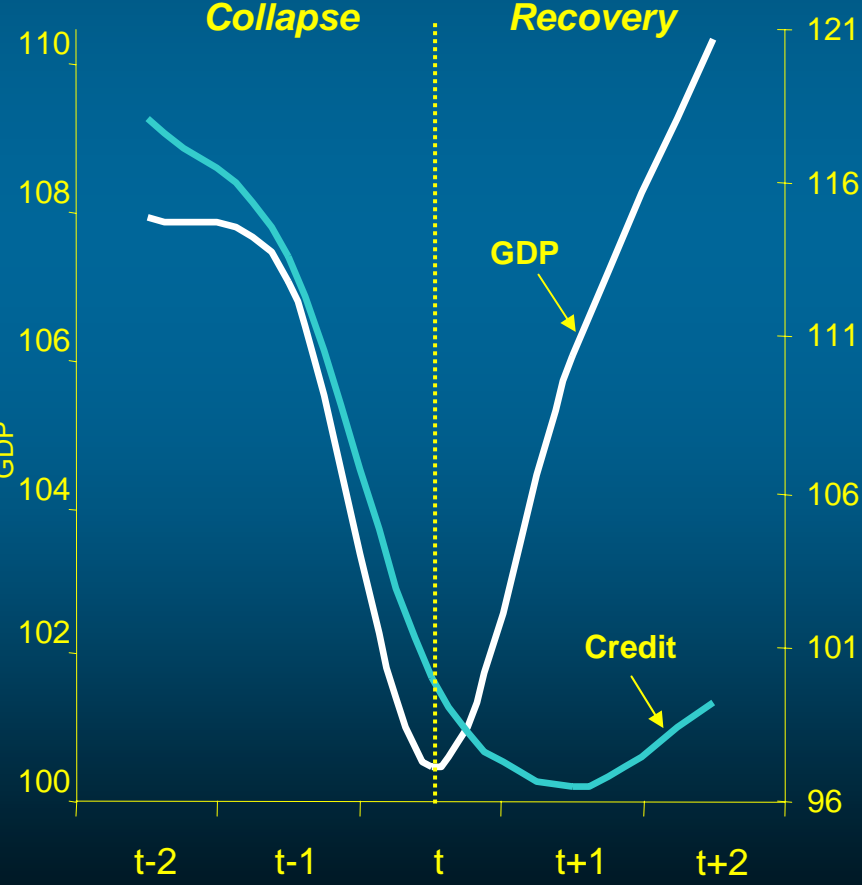
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 - ❖ *Total Factor Productivity*
 - ❖ ***Domestic Credit***

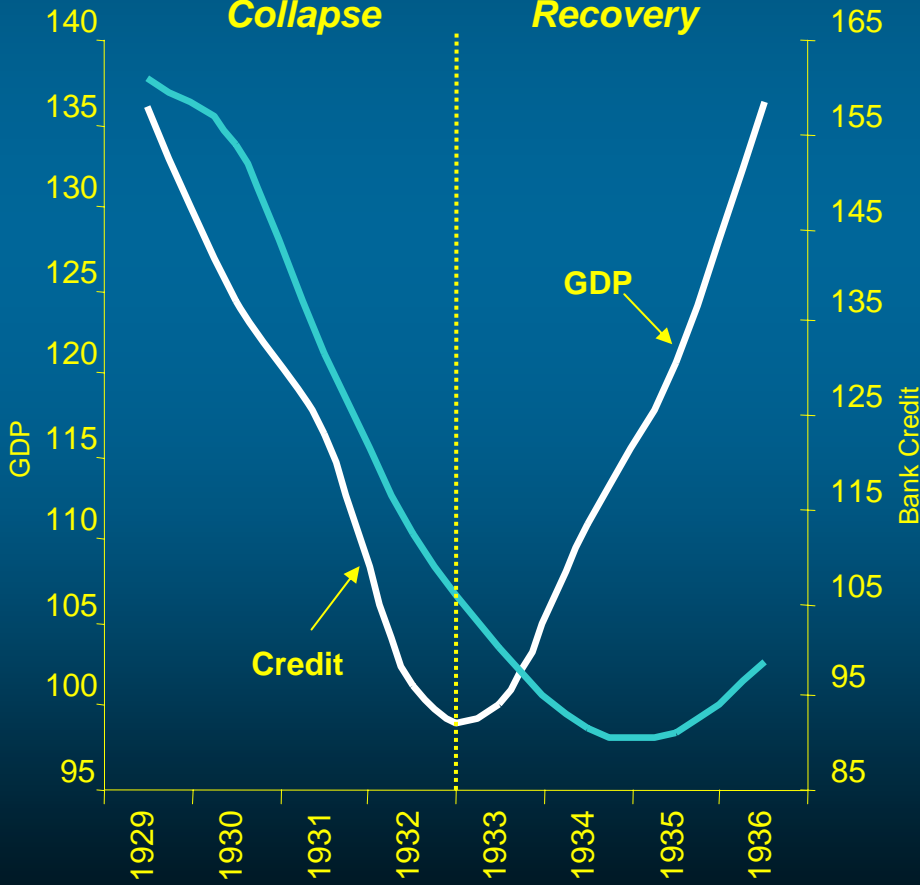
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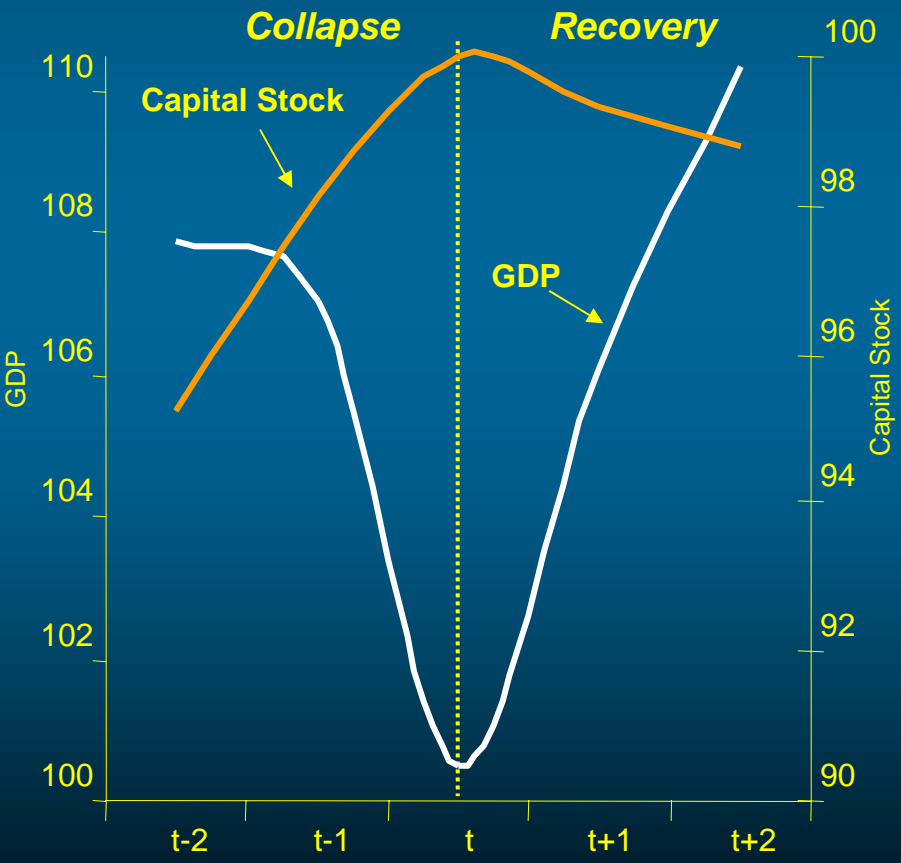
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 - ❖ *Domestic Credit*
 - ❖ ***Capital Stock***

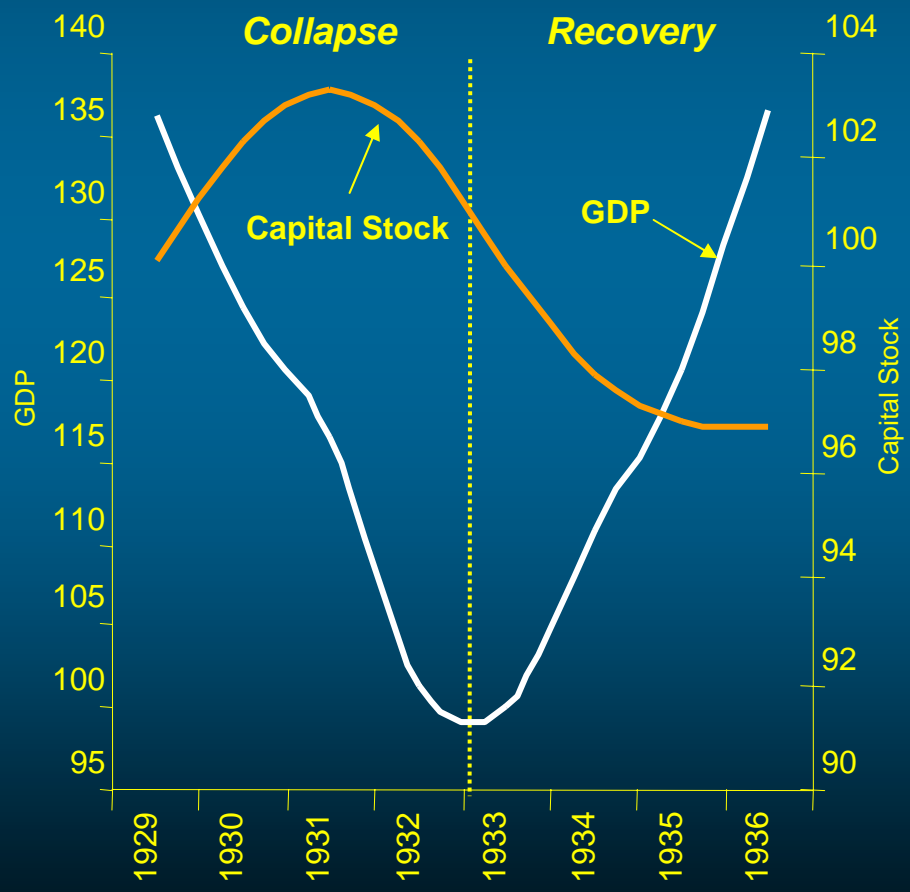
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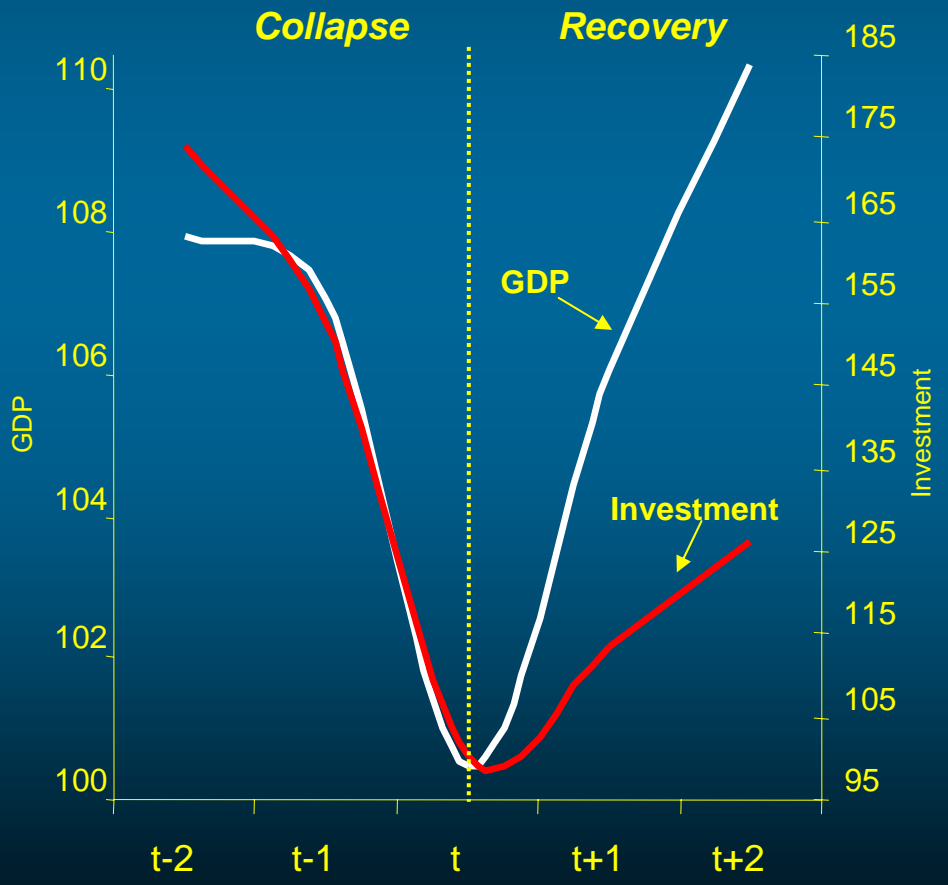
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 - ❖ *Total Factor Productivity*
 - ❖ *Domestic credit*
 - ❖ *Capital stock*
 - ❖ ***Investment***

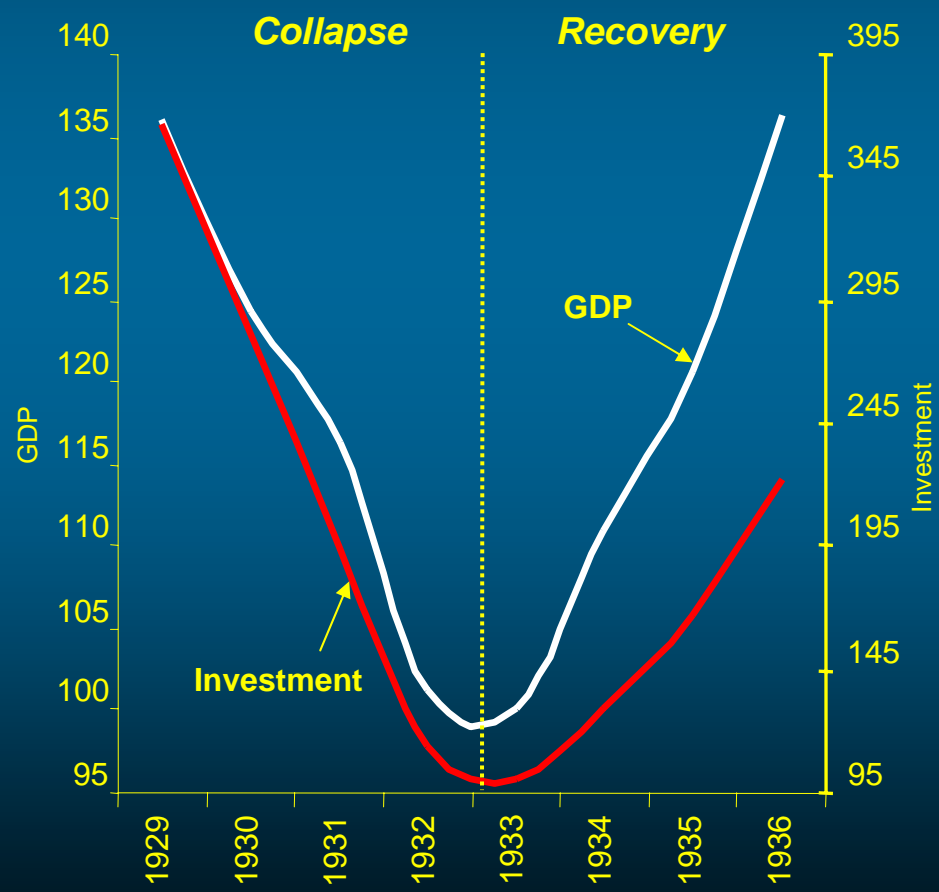
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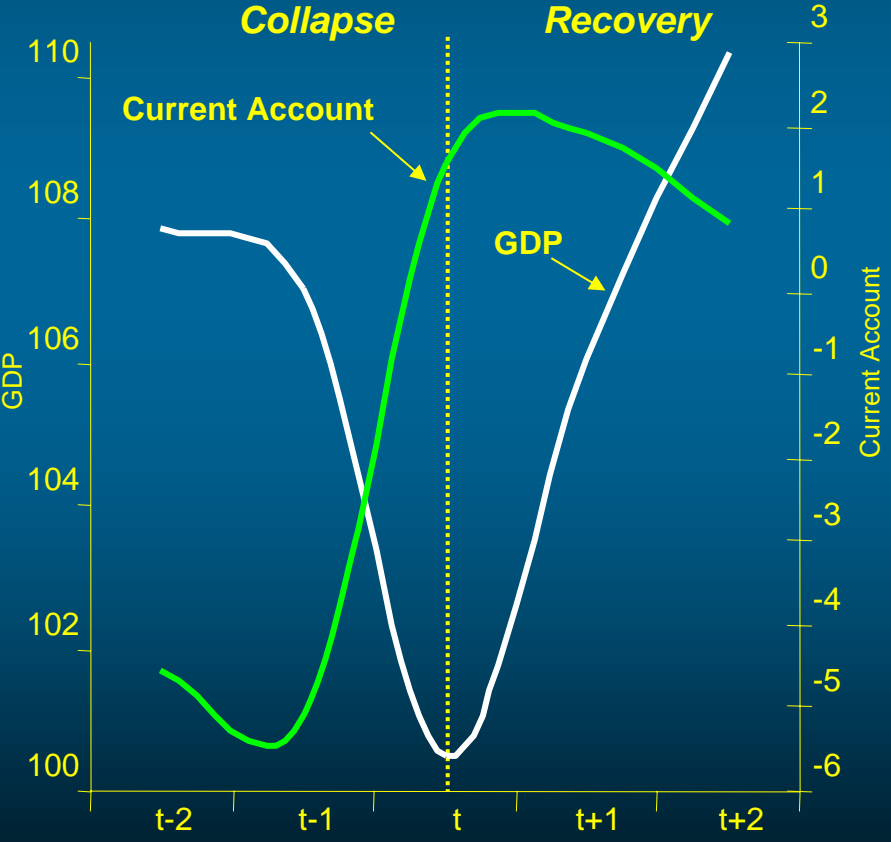
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 - ❖ *Total Factor Productivity*
 - ❖ *Domestic Credit*
 - ❖ *Capital Stock*
 - ❖ *Investment*
- ***...However, the US Great Depression differs substantially from output collapses in EMs in many other aspects***

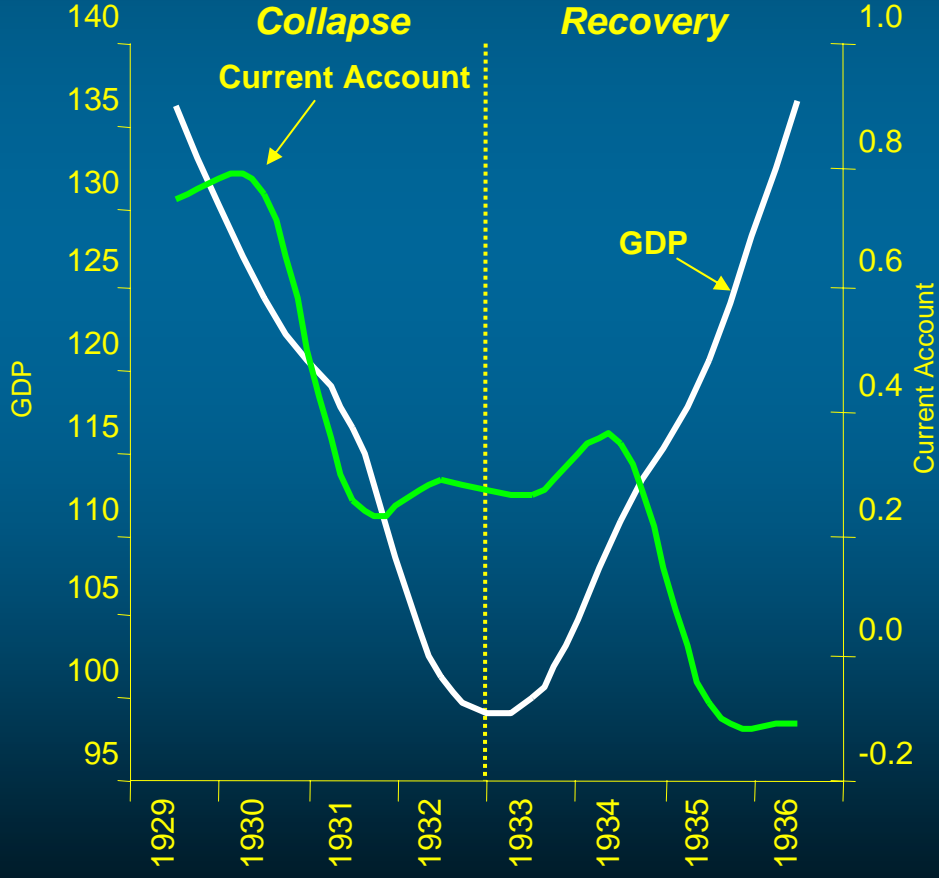
EM Collapses & the US Great Depression: Differences

- Current Account % GDP -

Collapses in EM Economies



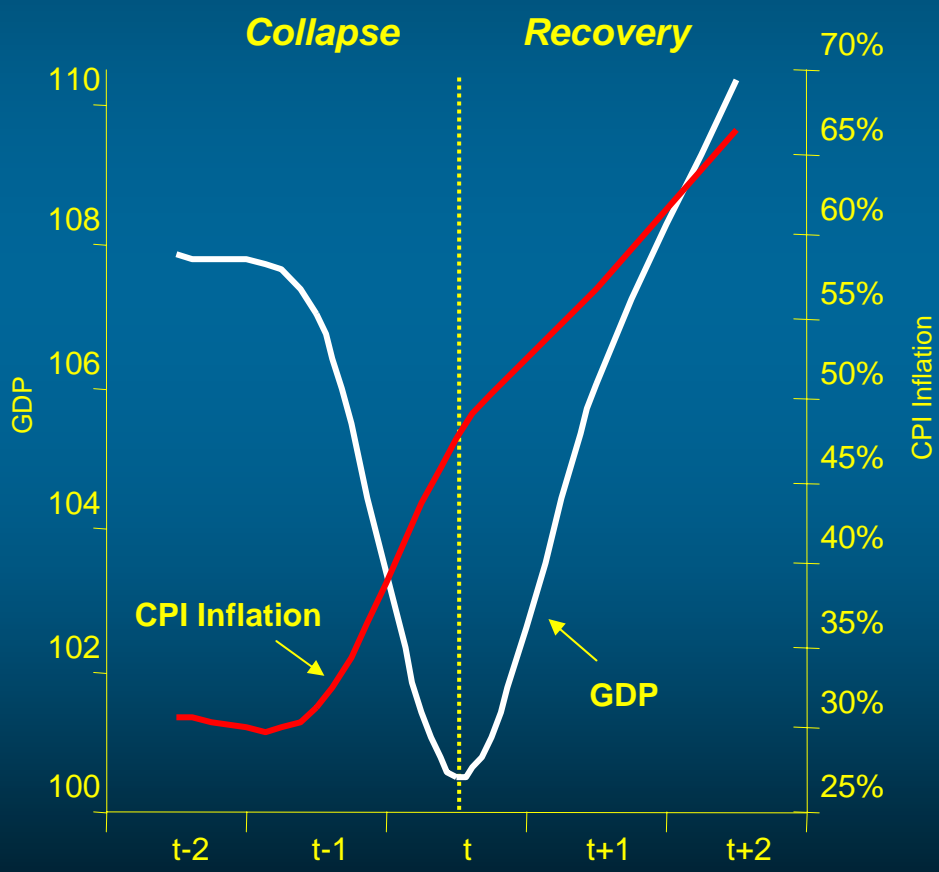
US Great Depression



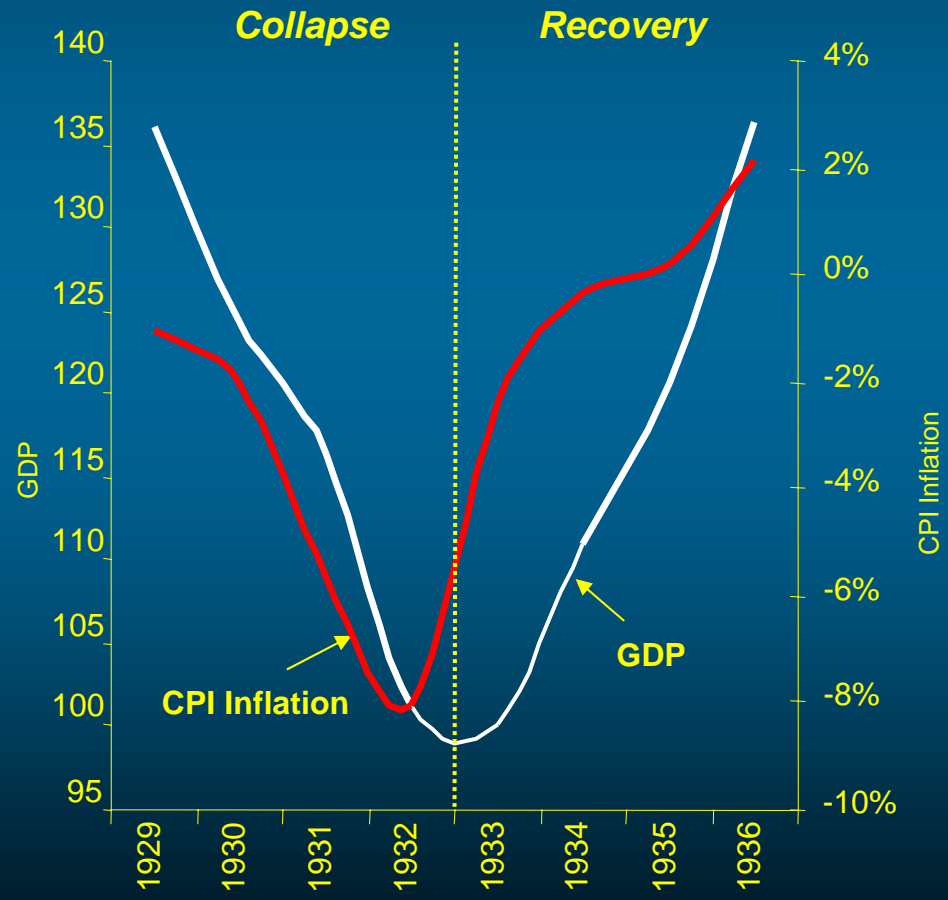
EM Collapses & the US Great Depression: Differences

- CPI Inflation -

Collapses in EM Economies



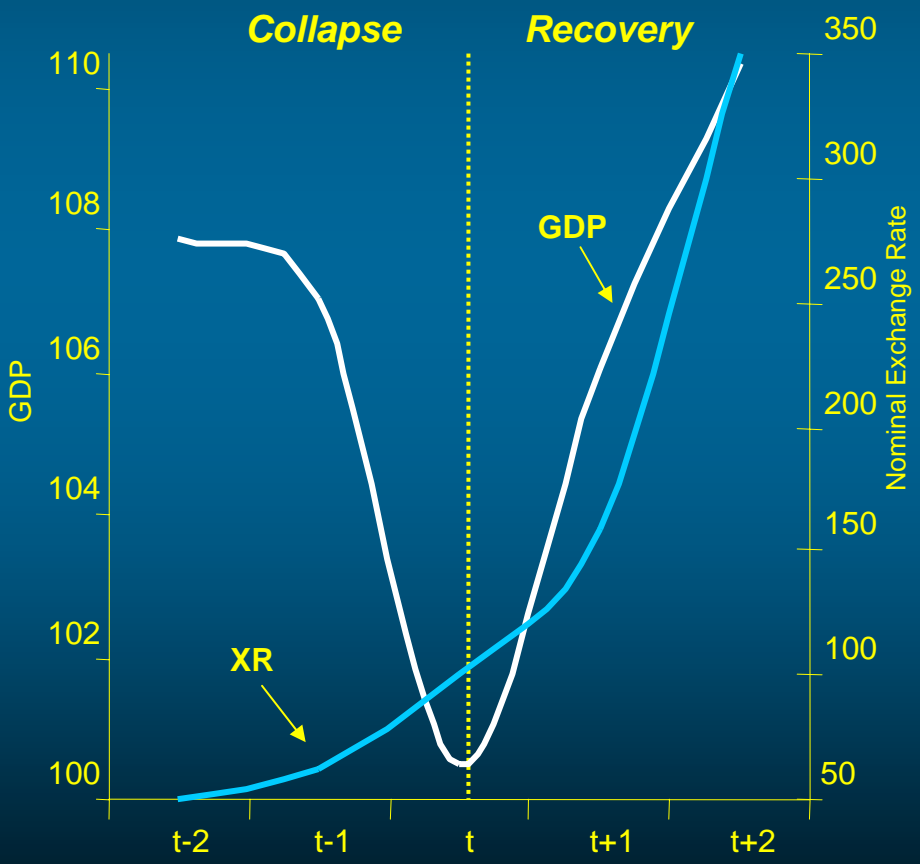
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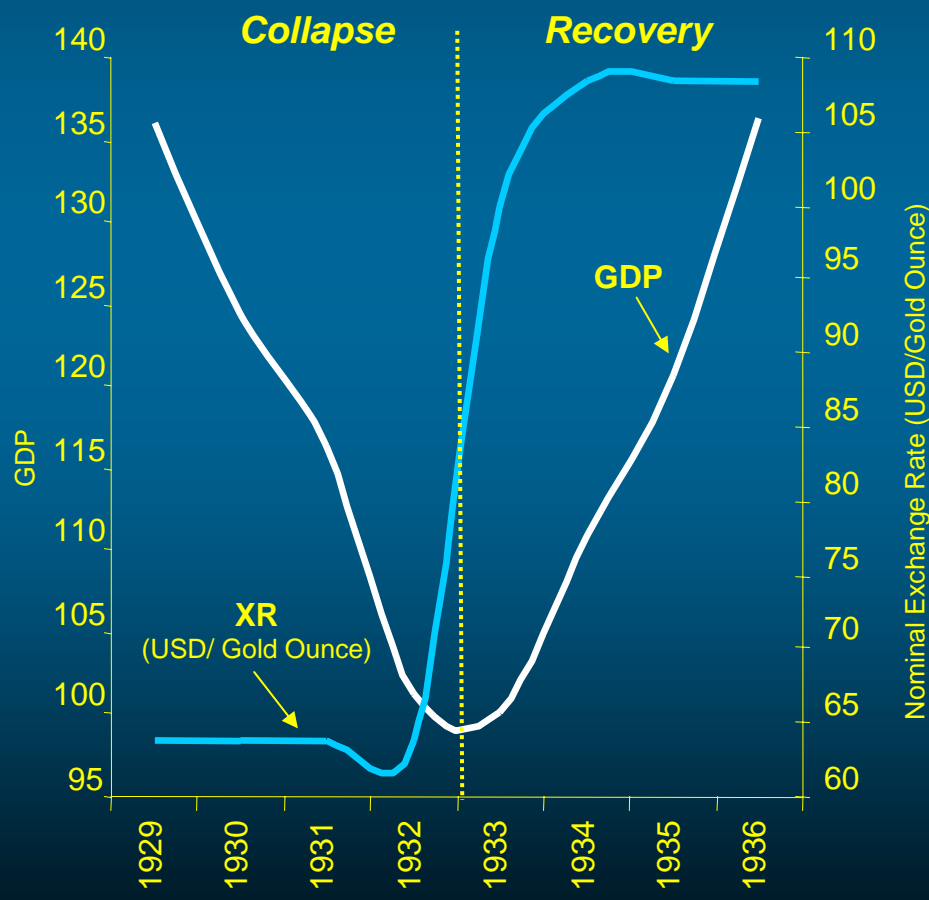
- Nominal Exchange Rate -

Collapses in EM Economies



US Great Depression

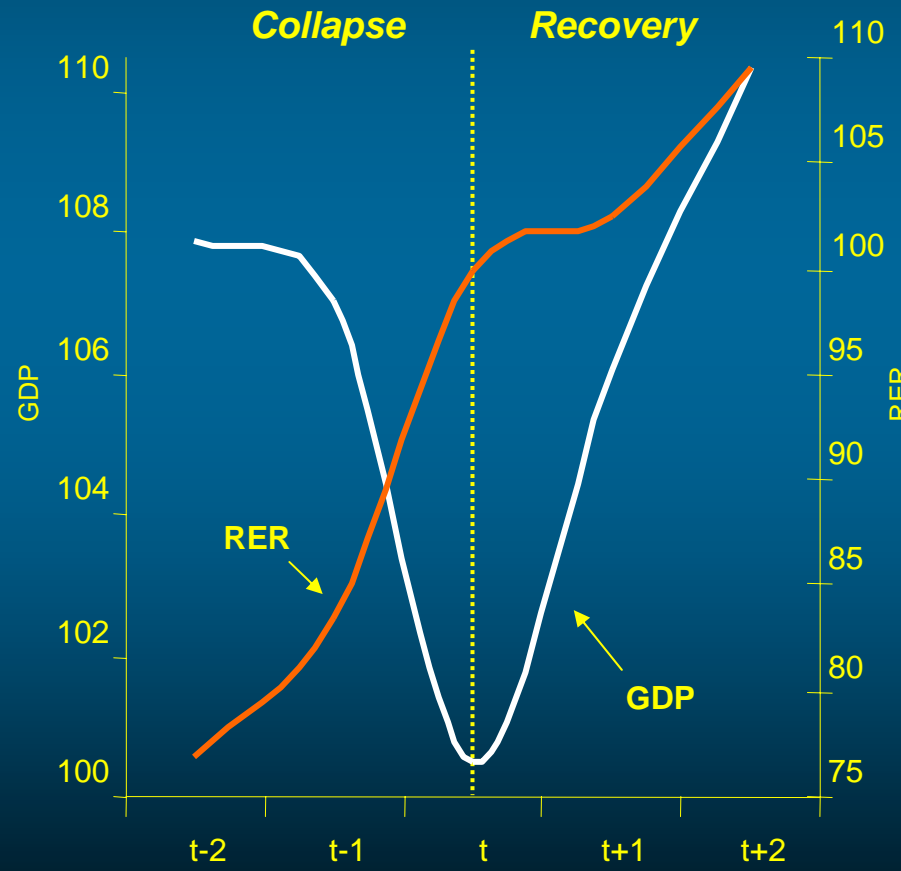
(Gold, USD/Ounce)



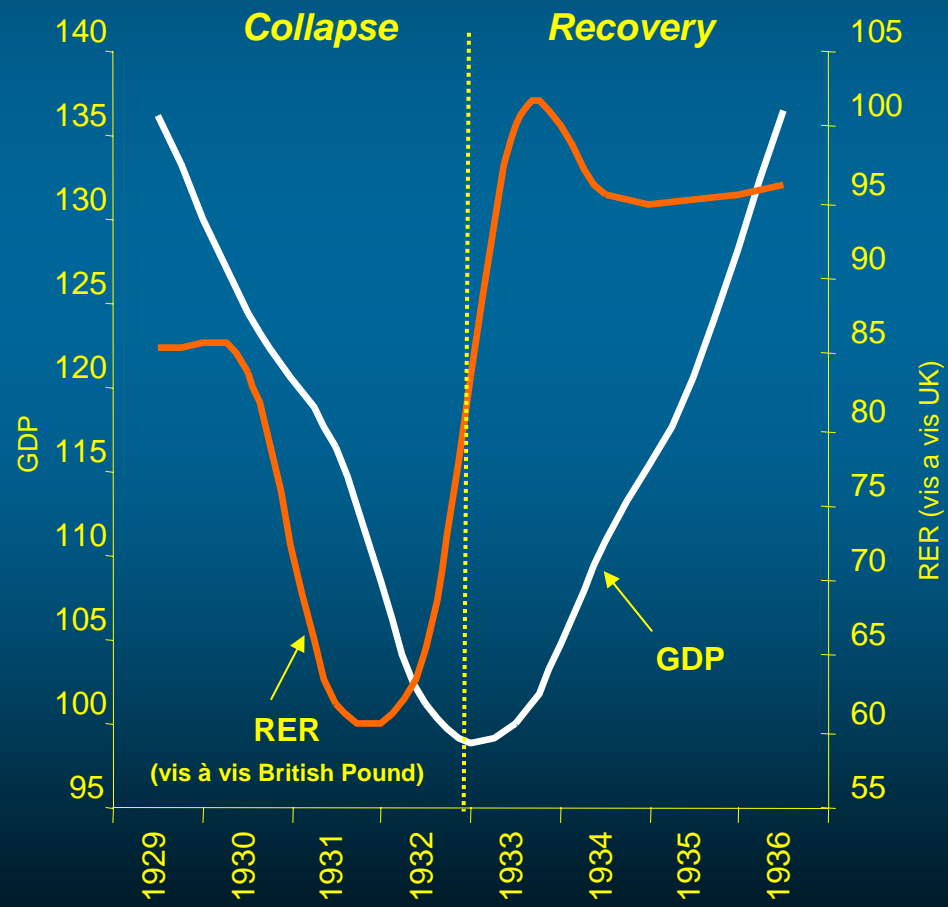
EM Collapses & the US Great Depression: Differences

- Real Exchange Rate -

Collapses in EM Economies



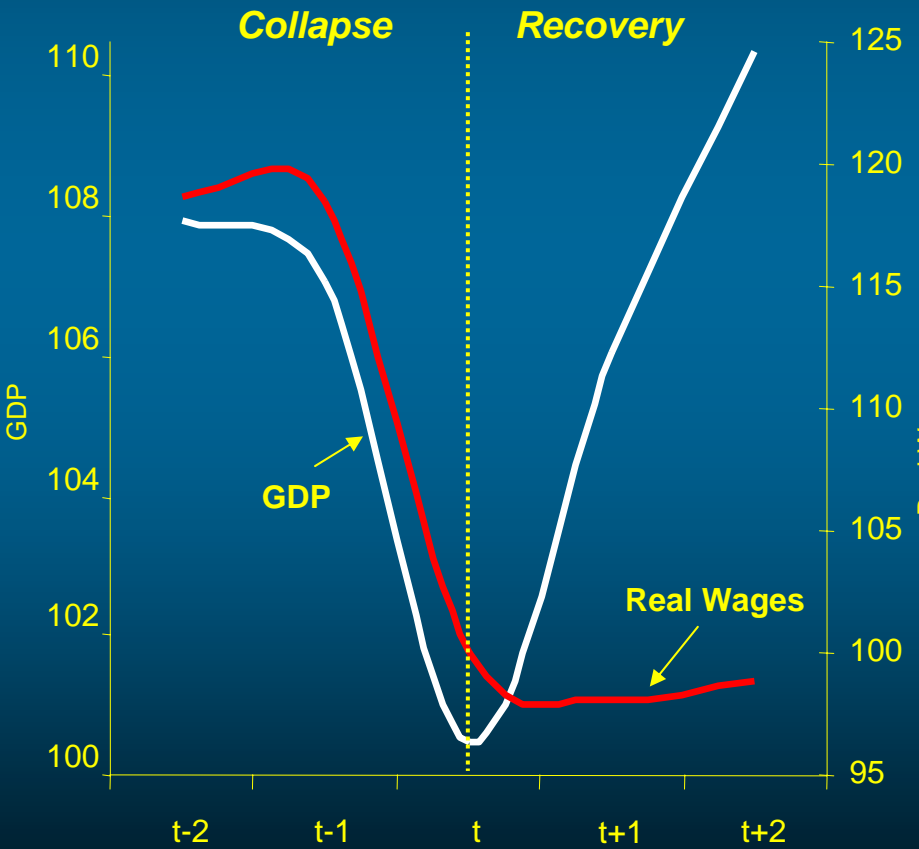
US Great Depression



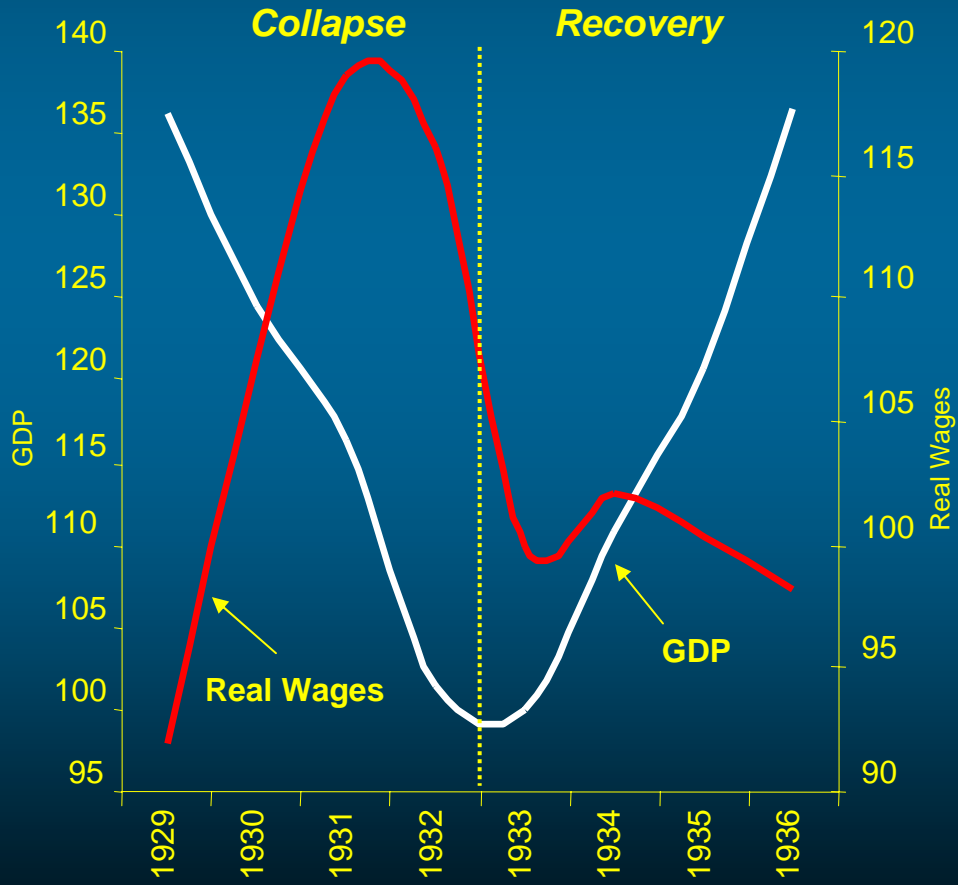
EM Collapses & the US Great Depression: Differences

- Real Wages - (deflated by WPI)

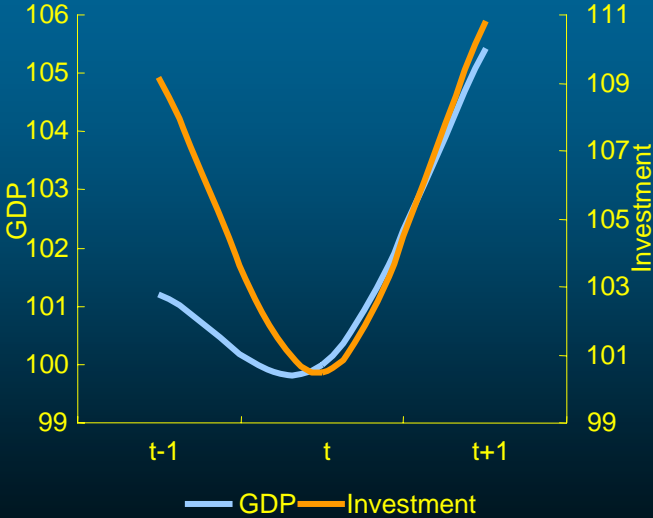
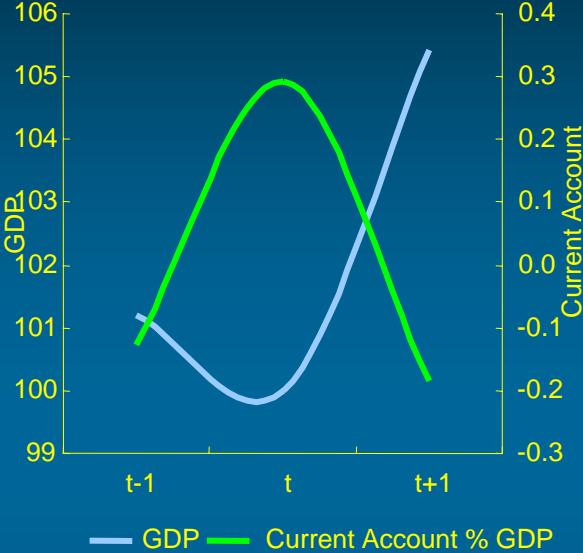
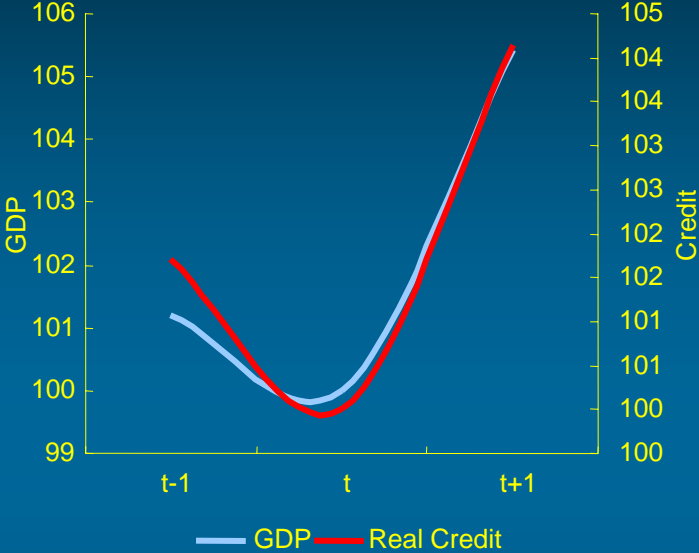
Collapses in EM Economies



US Great Depression



Mild Recessions in the US



Implications and Policy Issues

Implications

- Price deflation and wage rigidity play a central role in the discussion of the US Great Depression
- However, these factors are non-existent for EMs crises.
- Financial factors, especially contraction and non-recovery of bank credit are relevant for both.
 - Moreover, output collapses in EMs are typically accompanied by banking crises, as in the Great Depression.
- Moreover, Irving Fisher's Debt Deflation (Econometrica 1933) is a close relative of Liability Dollarization in EMs.
- **This suggests that *financial factors* could be key to explaining the viciousness of the worst EM crises and the US Great Depression.**
- **Moreover, price/wage flexibility may not be effective for preventing crises, *unless they help to deactivate the financial bomb.***

Crisis Prevention

- **Global policies aimed at reducing the likelihood of 3S**
 - Trade Integration agreements with the *North*
 - Code of Conduct for debt restructuring
 - Global Lender of Last Resort

- **Domestic policies aimed at reducing financial vulnerabilities**
 - Self-Insurance
 - Mitigation of excessive short term lending
 - De-dollarization

Dubious Policies

➤ Controls on Capital Inflows

- ❖ Capital outflows may occur even if there were no capital inflows, e.g., as a result of a bank run
- ❖ Large current account adjustment may take place even if there is no capital outflow
- ❖ Empirical evidence casts serious doubts about the effectiveness of capital controls, e.g., Chile

➤ Floating Exchange Rates

- ❖ Dangerous under Domestic Liability Dollarization

➤ (after crisis) Expansionary Fiscal-Monetary Policies

- ❖ Fiscal expansion unfeasible if government is part of the problem
- ❖ Monetary expansion:
 - requires control on K outflows under fixed exchange rates
 - may trigger inflationary expectations under floating exchange rates
 - However, tight fiscal and monetary policy may be counter productive

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