EMERGING ECONOMIES FACED WITH THE DOWNSIDE OF FINANCIAL GLOBALIZATION: HEDGES AND WAY OUTS

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Abstract: *The underlining assumption of this paper is that developing countries are in a fragile state nowadays. Economically, they have been seriously harmed by the 2008 crisis1 but this is not the end of the story: the future still has pitfalls in which these economies might get trapped, due to their enhanced vulnerability to exogenous shocks generated by financial globalization. Ideologically, the recent events have triggered a serious backlash against capitalism, particularly the Anglo-Saxon template. Getting an insight into the causes and implications of global economic crises is therefore critical for policy-makers in emerging economies. History might be a good adviser in this respect. Lessons from the past are even more important for ex-communist nations, whose confidence in capitalism's potential is still shaky. Some of the possible hedges against and/or way outs from such scourging events are discussed in the paper.*

Keywords: *financial globalization, money mercantilism, currency crises, international reserves, speculative attacks, capital controls, regulation*

JEL classification: *F41*

1. GLOBAL FINANCIAL INTEGRATION: A MIXED BLESSING

1.1   The impact upon economic development is not clear-cut

International finance is the economic sector where global capitalism has been most dynamic but also most controversial from the standpoint of its effects upon emerging economies. On the one hand, the surge in capital flows to developing countries during the last twenty years has most certainly fostered their economic growth. According to Mishkin (2007), „the evidence that financial development and economic growth are linked is quite strong". Ever greater amounts of incoming FDI have enabled developing countries to benefit by higher capital accumulation, acquire expertise in dealing with financial issues, upgrade their financial services sector etc.

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On the other hand, capital mobility across national boundaries means higher risk for host-economies: beside potential speculative attacks on their currencies, economies with large amounts of short-term capital inflows are continuously menaced by macroeconomic destabilization due to portfolio investors' unexpected behavior: when the "hot money" flows in, effects are positive: the cost of capital for local companies will edge down while wages will be driven up; when the "hot money" flees the country, "it will leave a currency crash in its wake, throwing the economy into a sharp recession". (Frankel, 2005)

Obviously, the above depiction of financial globalization impact is quite vague before being incomplete. As concerns western investors, the amounts of capital they venture overseas are expected to yield higher rates of return than they would if were invested at home; besides, emerging markets allow them to diversify their portfolios internationally. On the opposite side, benefits are less clear-cut: firstly, it is hard to ascertain accurately to what extent foreign short-term capital helps to improve host-countries' macroeconomic condition (lower inflation, lower external deficits etc.) Bosworth et al. (1999) contend that at least in part, "positive effects are cancelled out by other perverse ones such as increased consumption and capital outflows". Secondly, according to Rodrik (2001), for developing countries global financial integration seems to be politically disruptive as well, by prompting governments "to divert human resources and administrative capabilities away from more urgent development priorities such as education, public health, industrial capacity etc."

The difficulty in ascertaining the impact of financial globalization upon developing countries' economic growth should not be surprising. The more general relationship between finance and growth is not easy to grapple with either. On a broader plan, the contribution of finance to economic performance is a function with three variables: long-term economic growth, poverty reduction, economic activity and incomes stabilization (World Bank, 2001), the first one being perhaps the most significant.

In principle, it may seem obvious that full-fledged financial systems support faster economic growth; yet it is not easy to demonstrate. King and Levine (1993) found that many financial development indicators (e.g. the size of the formal financial intermediary sector relative to GDP, the importance of banks relative to the central bank, the ratio of credit issued to private firms to GDP and others) are strongly and robustly correlated with growth. Levine and Zervos (1998) further tried to prove that stock market liquidity and banking development were both positively and tightly correlated with present and future rates of economic growth, capital accumulation, and productivity growth.

1.2   Trade in money exceeds trade in merchandise

Financial globalization has ushered in a new type of gap: the international division of money. If the division of labor has increasingly got a core-periphery configuration, in which rich countries belong to the core, while poorer ones are relegated to the periphery of the world economic system, so does the global flow of money: financial markets integration has put high pressure upon emerging, soft-currency economies, most of which are dollarized. Dollarization is a two-way road: when the hard currency flows in, it is an anchor, supporting economic development; when it flows out (for whatever cause), wealth will be transferred from the periphery to the core. The process, coined "money mercantilism" (Allen, 2000) has become prevalent relative to trade mercantilism and no less effective than the latter.2 It is typically carried by financial intermediaries and tends to make the core wealthier and the periphery poorer.

Money mercantilism has many a facet, none of them working in the benefit of emerging economies. The latest innovations in the field of arbitrage such as carry trade are not of great help either. These types of business, mostly undertaken by hedge-funds on Euromarkets are highly destabilizing before being inherently risky. Schemes may be technically new but they are embodying an "old type of thinking" (Tilman, 2009): one takes out a loan on a certain market, in a certain currency, at a lower rate, and then one lends the money on a different market, in a different currency, at a higher rate: alternatively, the funds may be invested in higher-yielding securities for a profit. Such "games" enhance volatility and distort the price signals on emerging financial markets.

Briefly, the impact of financial globalization upon emerging economies is hard to gauge because long-term positive effects are sometimes offset by short-term negative ones, chiefly resulting from financial liberalization and extensive money mercantilism. Ultimately, the net effect depends on the soundness of the financial sector. Loayza and Rancière (2006) contend that development is subject to the degree of financial depth but also to the degree of financial fragility: the former supports growth while the latter is a prerequisite for financial crises.

1.3   The anatomy of a currency crises

Financial globalization is thus a hazardous blessing: fostering economic development on the one hand; paving the way for financial cries, on the other hand. To understand how this happens, let's making use of a simple monetarist model. The diagram in figure 1 illustrates the effects of an exogenous factor (an increase in world prices) upon a small open economy that is heavily dependent on imports, i.e. the price-elasticity of the domestic demand for imported goods and services is low. If the money supply is given, the balance of payments (BP) is a function of the domestic money demand (Md), which depends on the domestic price-level (P),

measured on the horizontal axis; as prices increase, people will adjust their actual money holdings to their desired money holdings through hoarding cash (i.e. savings exceed investments). If the purchasing-power parity (PPP) condition holds, domestic prices depend only on the foreign price-level and the exchange rate (e), which is, for the moment, presumed fixed. According to Dornbusch (1973), the balance of payments can then be expressed through the hoarding function, as follows:

$$BP = H = \beta \ (M^d - M) = \beta \ (KPY - M) = \beta KPY - \beta M \tag{1}$$

where, β = the speed of adjustment from actual to desired money balances;
          K = the desired ratio of money to income;
          M^d = the nominal money demand;
          P, Y and M = domestic price-level, national income and nominal money supply respectively.

From (1), one can infer that the BP is an increasing function of the price-level, with the slope equal to βKY. If the exchange-rate is pegged, the money supply is an endogenous variable, consisting of two components: domestic credit and international reserves. (Whitman et al., 1975) Under globalization, national economies are generally subjected to at least three kinds of pressures: (i) world prices fluctuations; (ii) FDI inflows and outflows; (iii) speculative attacks on the domestic currency. The first two are exogenous factors with a direct impact on the domestic demand for money and implicitly on the country's balance of payments, while the third will exert pressure upon the exchange-rate.
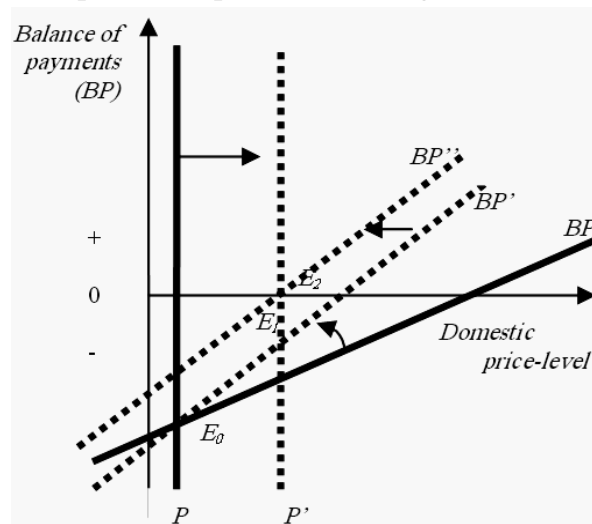

Figure 1 *Effects of foreign prices increase and monetary expansion on the balance of payments in a simple monetarist model*

If the price-elasticity of the foreign demand for the country's exports is also low (meaning that the Marshall-Lerner condition does not hold), an increase in the world prices will lead, with great likelihood, to a terms of trade deterioration and a deficit in a balance of payments for the economy under consideration (in figure 1,

the initial equilibrium is located in point E0). The increase in world prices (no matter the cause) will, due to the PPP condition and exchange-rate fixity, trigger an increase in the domestic price-level in the same proportion (the P line will shift rightward, to P'), causing a rise in the domestic money demand and a reduction of the balance of payments deficit.3 Now let's suppose that, at the same time, the amount of foreign capital flowing into the country is also growing, stimulating domestic output growth. The rise in Y further enhances the domestic money demand; yet the BP curve will not shift rightwards; it will simply rotate in the counterclockwise sense (around point E0), so it becomes steeper. (Caves, Frankel, Jones, 1993) The economy moves toward a new equilibrium in E1, where the BP deficit is lower than before but the domestic price-level has risen. 4

The problem with the above scenario is that it only catches the economy's adjustments in the short-run; yet for a longer time-horizon it is far too optimistic. Actually, the monetary approach seeks to combine long-run behavior with short-run adjustments. (Mussa, 1974) To resume the above analysis, in the new equilibrium state (marked by point E1), the authorities have two alternatives in order to diminish or do away with the BP deficit: a) to expand the monetary policy; b) to devalue the currency. Regarding devaluation, in the real world, developing countries' governments are often either reluctant – they may fear a possible loss of credibility (Sarno/Taylor, 2001) – or unable to devalue their currency (the economy may be tied up in a currency-board or other kinds of pegging arrangements). Monetary expansion is therefore more likely to be preferred to devaluation.

The increase in the money supply caused by an expansionary monetary policy will make the BP curve shift leftward until it crosses the P' line in E2. The BP is again in equilibrium, the exchange-rate is unchanged but the cost is a higher price-level and an increased money supply. The problem with the new equilibrium is that it is fragile (let alone the fact that the prospects of rising inflation are now daunting); it cannot be maintained unless the authorities are able to sustain the value of the currency. Keeping the exchange-rate at a fixed level may nevertheless be a difficult a task to fulfill, especially when governments must run high budget-deficits.5 In this case, combined operations of monetary, fiscal, and exchange policies are required: the central bank must finance the budget deficit through open-market interventions. (Mundell, 1963)

The economy is thus facing a trade-off: should the authorities – facing the menace of rising inflation – manifest strict determination in keeping the exchange-rate fixed, their obstinacy might nevertheless put the macro-equilibrium in jeopardy: the pegging effort will at some point collapse in a sudden balance of payments crisis (Krugman, 1979), causing depletion of international reserves. The central bank must buy high amounts of government debt-securities on the domestic market, on the one hand, and sterilize their purchase by a sell of foreign reserves (against domestic

currency), in the same amount, on the other hand. In this process, the central bank may run out of international reserves (the loss depends on the size of the deficit) and at a certain moment, it may become unable to further support the exchange-rate6. The currency crisis is looming.

Should foreign investors expect the domestic currency to be devalued in the near future, they will claim higher interest rates, to compensate for a prospective loss. Unless speculators get this compensation, assuming perfect assets substitutability, there will be a private capital flight from domestic toward foreign assets. It follows that central bank's sterilization of the money supply (referred to above) has no effect under a fixed exchange-rate regime: due to speculative attacks, the central bank must keep on selling foreign reserves until the equilibrium is restored in the money market at a higher interest rate. Ultimately, the central bank may run out of foreign exchange reserves. When this happens, the currency will be allowed to float; the switch to a floating exchange-rate regime, compounded by a rise in the domestic price-level will generate further capital losses.

2. HEDGES AGAINST AND WAY OUTS FROM FINANCIAL STORMS

2.1   Wise skippers at the helm

Scores of developing countries are scrambling to entice foreign investors but few of them are duly equipped to manage the incoming foreign capital in such a way so as to extract maximum of benefit thereof. Unfortunately, not infrequently, policy makers in developing countries lack "the degree of sophistication needed to interpret research results, which might enable them to make up and apply the most effective economic policies". (Krueger, 1997) In the case of the new EU member states in Central and Eastern Europe for example, recent studies (Kittelmann et al., 2006) have shown that the majority of crises that had occurred in those countries in the last ten years were due to "inconsistencies in the domestic policy mix, which contributed to the deterioration of their macroeconomic condition".

Macroeconomic mismanagement has (with few exceptions) become apparent in the context of global banking expansion. The fact that the massive penetration of foreign banks into emerging economies was driven by western bankers' wish to make quick profits cannot be denied; but it is no less true that this penetration was eased a great deal by the crisis local banking systems were mired in. Commercial banks, mostly state-owned were burden with bad loans, requiring recapitalization and reformation (World Bank, 2008). On the other hand, host economies proved institutionally, ill-prepared to receive great amounts of foreign banking capital because they lacked the necessary prudential regulatory and supervisory structures. (Mishkin, 2007) From the market perspective, this tendency has created enhanced dependence on foreign banks financing, entailing extra risks. The larger the share of

the domestic credit market seized by overseas banks, the higher the risk for local banks to run out of liquidity should the former impose restrictions on lending. In the expansion phase, these things were nevertheless less apparent. In fact, foreign banks pumped high amounts of liquidity into their subsidiaries located in emerging economies. The resulting expansion of local credit markets was accompanied by an increase in the prices for assets such as real estate and stocks. Conditions for the formation of asset price bubbles were thus ripe. The burst of the bubble pushes the economy into a liquidity spiral: funds dry up, banks are no longer able to roll over their short-term debts, markets shrink.

However, governments of emerging economies do have a few possibilities at hand in order to prevent financial crises. Firstly, more attention must be devoted to early warning signals. The deterioration of macroeconomic fundamentals (GDP growth, external balance, interest rates and inflation levels etc.) is such a signal. Reality has shown that if the worsening of fundamentals (especially the rise in the current account deficit) goes hand-in-hand with a real appreciation of the domestic currency, this is a sign that future attacks on the currency will ensue. Should problems within the banking sector arise, this will be another signal. Secondly, one must be aware that banking and currency crises are closely entwined so that scholars now speak about the "twin crises" phenomenon. (Kaminsky/Reinhart,1999) The banking and currency crisis literature finds that monetary aggregates, such as domestic credit, are among the best predictors of crises and their related economic downturns. At any event, one must pay attention to early warning signals and react accordingly.

2.2   International reserves aren't always a safety cushion

One important issue that is hotly debated nowadays is related to central banks' interventions in the foreign exchange market, aimed to forestall an impending depreciation of the home currency that might push the economy into a full-blown crisis. Such interventions obviously require substantial holdings of international reserves by the central bank. However, to what extent are these holdings a safety cushion against currency crises is far from clear. Asian countries are clearly behind the idea that amassing high amounts of foreign exchange is an insurance policy for times when the economy is in dire straights.[7] This is most certainly due to the painful experience of the 1997 crisis, when the IMF stepped in to bail out these economies. The conditionality attached to IMF's loans provoked strong political opposition and even a backlash against the Fund's policies.

However, reality has shown that hoarding foreign exchange reserves might turn out to be a risky undertaking. In case of a major downturn, not only may the goal of keeping the foreign exchange rate from falling not be attained but the central bank can wind up in a depletion of reserves and eventually, have no alternative but

let the currency float freely. The problem is thornier than it seems because it is not solely a question of cost; it is, above all, a question of opportunity in the sense that the intervention must be subject to the nature of the factors that had sparked off the exchange-rate change. If this was due to a change in real factors such as a decline in the terms of trade or a deviation from the purchasing power parity, the problem will not be solved through government foreign exchange market transactions. (Stockman, 1980) Besides, there always exists an alternative, involving a trade-off between the net benefits from changing the exchange rate versus defending it. (Obstfeld,1995) By using the simplest of Brainard's models (1967), with one target and one instrument, the optimal policy under uncertainty conditions can be derived from the linear relationship between policy targets and policy instruments. This can take the following form:

$$m = f(H) + \varepsilon \tag{2}$$

where, m is the vector of central bank objectives (here, of size one[8]),
H is the vector of policy instruments (here, of size one too[9]) and ε is the vector of exogenous variables.

The linear equation can be written as follows:

$$m = \alpha H + \varepsilon \tag{3}$$

where α denotes the economy's response to the policy action, which is, in itself, a major uncertainty.

A second uncertainty is related to the impact of the exogenous variables (ε) upon the target variable (m). Clearly, these two types of uncertainties have different relevance: while the latter does not bear upon policy decisions, the former has important implications thereupon. Now let's suppose the desired value for m is m^*. Because of the mentioned uncertainties, the attainment of the m^* target is also uncertain. Under these circumstances, the policy actions are aimed at maximizing the expected value of the utility function, which takes the following quadratic form[10]:

$$U = - (m - m^*)^2 \tag{4}$$

Considering the most general scenario (α is a random variable, correlated with ε), the variance of m is given by:

$$\sigma_m^2 = \sigma_\alpha^2 H^2 + \sigma_\varepsilon^2 + 2\rho\sigma_\alpha\sigma_\varepsilon H \tag{5}$$

where σ_α^2, σ_ε^2 are the variances of α and ε respectively, and ρ is the correlation coefficient between α and ε.

One can determine the expected utility from a given policy action by introducing the mean and variance of m into the utility function, as follows:

$$E\ (U) = -\ [(\overline{m} - m^*)^2 + \sigma_m^2\ ] = -\ [(\overline{\alpha}\ H + \overline{\varepsilon} - m^*)^2 + \sigma_\alpha^2 H^2 + \sigma_\varepsilon^2 + 2\rho\sigma_\alpha\sigma_\varepsilon H\ ] \tag{6}$$

where, $E\ (U)$ is an expected value operator.

$\overline{m}$ and $\overline{\varepsilon}$ are the expected values of m and ε, respectively. Since equation (6) is quadratic with negative coefficient, it will admit a maximum, which can be determined by differentiating with respect to H and setting the derivative equal to zero. The optimal value of H is:

$$H^* = \frac{\overline{\alpha}(m^* - \overline{\varepsilon}) - \rho\sigma_\alpha\sigma_\varepsilon}{\overline{\alpha}^2 + \sigma_\alpha^2} \tag{7}$$

The model may be further developed by introducing an additional independent random variable, say, a vector of non-policy exogenous variables (L[11]) and a restrictive condition. Equations (2) and (3) then become:

$$m\ (H,L) = \alpha H + \beta L + \varepsilon \tag{8}$$

subject to

$$g\ (H,L) = t \tag{9}$$

Variables α, β are random, ε is a vector of stochastic disturbances[12], and t is a constraint[13]. Optimization then implies maximizing (8), subject to the constraint (9). Although, according to Blinder (1998), this implies no less uncertainty, the problem can be solved by using the Lagrange multiplier. The contour lines of m and g touch when their tangent vectors are parallel. At inflexion points, gradient vectors are also parallel. It follows that the sought points must satisfy concomitantly equation (9) and the following:

$$\nabla_{H,L}\ m = -\lambda\nabla_{H,L}\ g \tag{10}$$

where, $\nabla_{H,L}\ m$ and $\nabla_{H,L}\ g$ are respective gradients i.e. vectors of partial derivatives with respect to H and L, of functions m and g respectively, and

λ is a constant that measures the difference in magnitude between the two pairs of vectors.

Optimization can then be reached by building a more complex function with 3 variables, as follows:

$$\Lambda\ (H,\ L,\ \lambda) = m(H,\ L) + \lambda[g(H,L) - t] \tag{11}$$

and making all 3 partial derivatives $\nabla_{H,L,\lambda}\ \Lambda(H,L,\lambda)$ equal to zero.

2.3   Currency boards: effective but risky

Few would deny that financial storms are often caused and even fuelled by exchange rates volatility. Many governments in developing countries will therefore opt for fixed exchange rate regimes as bulwarks against financial turmoil. However, pegging the currency may be twice risky: firstly, reality has shown that fixed exchange rate regimes would be most exposed to speculative attacks; secondly, as previously shown, when financial storms break out, keeping the domestic currency from falling can be a very difficult task.

When difficulties become overwhelming, governments are temped to adopt currency boards, which are an extreme form of pegging. Only, one must take account of the fact that this arrangement is a mixed blessing: the good part is that they are efficient means of building or restoring confidence in the domestic currency; the bad part is that central banks' monetary policy is practically frozen, which means that exogenous shocks cannot be easily absorbed. This thesis has been confirmed recently: various economies in Eastern Europe responded differently to exogenous shocks (such as the appreciation of the euro or the farming and energy prices hike), function of the type of currency arrangement in force. Countries with currency boards (e.g. the Baltics) were most severely hit: their exports' competitiveness declined while inflation rose to two digits. Countries non-engaged in currency pegs (e.g. Romania) managed to escape a hard landing.14 Currency boards are thus more effective as way outs from financial storms (as was the case of Bulgaria in 1997) rather than hedges against them.

2.4   IMF' s bail out schemes under fierce criticism

The possibility that the IMF should step in and bail out crisis-stricken economies is a source of much controversy nowadays. Although the mere possibility of IMF to intervene is reassuring, the way in which the Fund is fulfilling its commitments remains one of the hottest issues. The Asian crisis is a landmark in this respect: not only the assistance provided to countries hit by the crisis was lavisher but the Fund got more deeply entangled in their internal affairs than it had ever done before (Eichengreen, 1999), demanding excessive restrictions of monetary and fiscal policies. The results were considered disastrous by Stiglitz (2001): "the money went not to finance more expansionary fiscal policies but, instead, to bail out creditors from the more industrialized countries."

Studies so far have shown that today's crises tend to be more severe than the ones that occurred in the past and the discrepancy is most likely due to the availability of rescue packages from the IMF (Delong et al., 1999). Such packages are by no means the cause of crises but, by making investors and banks more willing to take on more risks, they make global capitalism more prone to crises.

2.5   Can governments save the day?

During hard times, people will expect a great deal from political leaders. Governments are supposed not only to alleviate the pain but to find means to avert future crises. In brief, they must solve and regulate, in this order.

Regarding the solving issue, the question is: how can governments fulfill this task? What should they start with? Obviously, if one takes account of the lessons from the past, banks must be on the top of the rescuing list. Prompt authorities' intervention by pumping liquidity into the system won't solve the problem but it might contain the losses. As Milton Friedman pointed out, the chain of bankruptcies that struck the US banking system in the early 1930s could have been contained had the newly-created Federal System decided to buy large amounts of government bonds…"Unfortunately, the Fed's actions were hesitant and small. In the main, it stood idly by and let the crisis take its course – a pattern of behavior that was to be repeated again and again during the next two years." (Friedman/Friedman, 1990)

A second question is: are governments supposed to save the banking system only? Aren't there other sectors that deserve as much to be rescued? After all, why not buy out entire industries thereby containing unemployment? Unfortunately, there are no straight answers to the above questions. All we know up to now – i.e. one thing on which most economists and politicians seem to agree – is that inaction from the part of the government can be deadly. (Hausken/Plümper, 2002) The failure by the Fed to save the legions of ailing American banks doomed to bankruptcy during the Great Depression stands as proof. As Joseph Stiglitz recently remarked, "banks have shown that they can't manage their own risk, and the consequences for others have been disastrous." (Stiglitz, 2009) That's true, but they must be kept from crumbling.

2.6   An old buzzword: regulation

Whenever the economy is faced with a downturn, an old buzzword, regulation begins to race up political agendas. But regulating the financial system can be as thorny an issue as solving crises. On the other hand, according to Stigler (1971), the existence of a problem is a necessary but not sufficient condition for regulation.

The task of regulating is hazardous the more so as it is difficult to establish precisely what the real causes of crises are. Is the central bankers' handling of the fiat money to blame? Or, are crises due to mistaken decisions made by reckless

politicians or greedy bankers? Government bureaucracies sometimes deliberately create problems or waste resources because they are constrained by the political process to pursue goals that have nothing to do with economic efficiency. This aspect undoubtedly lies at the core of the famous "sub-prime mortgages" story, which sparked the recent crisis.

But even admitting that financial system could be duly reformed at the national level, how to regulate the global financial system? According to empirical evidence, economic crises would hit countries where neither macroeconomic policy had been weak nor the economy had been overheating. (World Bank, 2001) The 1997 South-East Asian crisis for example, did not match usual macroeconomic instability standards. The crisis was sparked by a massive capital flight following the collapse of domestic asset market bubbles; it struck with extreme violence, provoking the collapse of the currencies in the region and making governments' intervention futile.

Does it follow that capital controls might be a solution? Or perhaps, would other related measures such as the Tobin tax on financial transactions do? Probably yes but there is hardly a consensus on this matter. Depending on the circumstances, capital controls can be viewed as hedges or way outs. Bhagwati (2005) for example, contends that capital controls had acted as a hedge for China and India, protecting them from the bad effects of the 1997 crisis. Kaplan and Rodrik (2001) emphasize the way Malaysia used capital controls as a means to yield a fast recovery from the same crisis.

In the long run, such steps would most likely hurt firms in emerging economies by impeding their access to cheap sources of capital on a global scale. Actually, emerging economies are suffering from their financial markets being too segmented, meaning that for firms in these countries, possibilities of sourcing capital globally are scarce and consequently, the weighted average cost of capital is relatively high.

Actually, the Asian crisis highlighted three major drawbacks of the contemporary global system: a) the world economic equilibrium seems to be more fragile than it was before globalization took prominence; b) the global financial system is improperly structured and managed. (Delong/Cooper/Friedman, 1999) As previously emphasized, fragility derives from the lack of bank and financial regulation, as well as well-established supervisory control institutions in many developing countries that wish to open up their economies to global competition. As regards the management of the system, some believe reforming the IMF i.e. offering developing countries more clout would solve the problem. I think this is mere wishful thinking. Even if the Fund is reformed, meaning that developing countries are allotted bigger quotas (and implicitly more votes) and even the Fund's liquidity is enhanced by lavish contributions from China and others, the moral hazard

problem remains. As The Economist has put it recently, "the main reason to reform the fund is the hope that countries will be more likely to heed the IMF' s advice if it is more representative."15

And a last question: how effective is regulation? As Black et al. show, "even when regulation is designed and intended to operate as a surrogate of the free market one cannot be confident that the consequences of regulation will be similar to what the free market would produce." (Black/Miller/Posner, 1978) This is nevertheless not to say that rules aren't necessary. They most certainly are, for the simple reason, brightly intuited by Mancur Olson, that "as bad as governments may be, it is a historical fact that people generally flee an area of anarchy to settle in areas with governments" (Olson, 1986).

3. CONCLUSIONS

This paper is anchored in the "depression economics" framework16, with the focus on emerging economies' specific issues. The author claims neither infallibility nor full comprehensiveness but simply wishes to draw the attention on certain weaknesses of the contemporary global financial system that might jeopardize emerging economies.

The recent crisis has revealed two clashing realities of today's world: on the one hand, many emerging economies are still financially fragile and hardly prepared to face global downturns; on the other hand, the financial globalization process is beneficial but hard to harness. Emerging economies must find means to capitalize on it.

The main idea the author wishes to transmit is the following: the effects of the recent crisis have been painful indeed for developed and developing countries alike. Globalization may be the culprit for the mess, but stopping globalization is definitely not the way. Good management and well-inspired economic policies may be a much better solution.

NOTES
1. Western companies have curtailed investment in developing countries due to a drop in confidence: if in 2007, the amount of cross-border capital flows into emerging economies accounted for 5% of their GDP, now it is much less. According to the IMF, banks, firms and governments in the emerging world have some $1.8 trillion-worth of borrowing to roll over this year, much of that in central and Eastern Europe. (*The Economist*, May 25th , 2009)
2. In the last decades, trade mercantilism shifted from western to newly industrialized economies from South-East Asia, primarily China. Yet in spite of their rapid economic growth, these economies became excessively dependent on exports. The recent plunge in exports, triggered by the global credit crunch has thrown them into deep economic trouble. (*The Economist*, Jan 31st , 2009, pp.62-63)
3. One must notice that, although the exogenous factor is a change in foreign prices of goods and services, it is not relative prices changes that concern us but the change in the overall price-level.

4. The BP deficit will be completely absorbed only in the event that the rise in income (following an increased capital inflow) is high enough to determine a more complete rotation of the BP curve until it crosses the *P* line on the horizontal axis. Such an outcome, though possible for certain sounder economies, will be, for most of the small countries, rather unlikely.

5. Reality has offered quite illustrative examples. Argentina for instance, in the late 1980s, ran huge public deficits, which the government tried to finance by printing money. "In 1989, Argentina's national mint churned out pesos at such a rate its printing presses broke down." (*Economics, Making Sense of the Modern Economy*, 6th ed. By The Economist, Profile Books 2006, p.173)

6. A situation of this type recently took place in Latvia, whose central bank "has burned through €1 billion ($1.4 billion), around a fifth of its reserves, since mid-October to defend the national currency, the lat." (*The Economist*, December 20th, 2008, p.44)

7. The Asian countries' holdings of international reserves are fabulous: China and Hong Kong together are holding about $2.3 trillion in reserves, while Japan's holdings amount to almost $1 trillion. Taiwan and Korea are holding about $300 billion each, Singapore about $200 billion, Thailand and Malaysia about $100 billion each. By comparison, the United States, Germany, France and the UK are holding together less than $200 billion in international reserves. (IMF – *International Financial Statistics; Financial Statistics of the Central Bank of China, Republic of China*; http://investintaiwan.nat.gov.tw/en/env/stats/foreign_exchange. html)

8. The sole objective is terms of trade improvement.

9. The sole instrument is the foreign exchange market intervention.

10. According to Brainard, the assumption that equation (10) is quadratic is not one of trivial significance; it means that positive and negative deviations from target are equally important.

11. *L* may signify, say, the tightening (loosening) of external financing conditions.

12. The relevance of this term depends on the circumstances; under a financial crisis for example, it might be much higher than usual.

13. The constraint might be the amount of international reserves available for intervention.

14. Central banks in these countries were unable to use either interest rates or exchange rates in order to diminish such effects. Because nominal interest rates were fixed (indexed at the euro zone level), real interest rates became negative, while monetary policy became pro-cyclical, encouraging consumption. By comparison, countries non-engaged in currency boards (e.g. Romania) did much better: the free float regime allowed disruptions to be, at least in part, adjusted by market mechanisms, while the central bank could wield interest rates to calm inflation. ("Romania will escape a hard landing of economic growth", interview with the Governor of Romania's National Bank, *Gandul* daily, 9 Sept., 2008, p.7)

15. *The Economist*, October 3rd, 2009, p.85

16. As 2008 Nobel laureate Paul Krugman recently noted, "while depression itself has not returned, depression economics – the kinds of problems that characterized much of the world economy in the 1930s but have not been seen since – has staged a stunning comeback". (P. Krugman – *The Return of Depression on Economics and the Crisis of 2008*, W.W. Norton & Co. Inc., 2009, pp.181-191)

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