Tensions in the Developing World

Lecture Summary

• Rise of the “Washington Consensus”
  – Alternative models of development (communism, autarchy (ISI), commodity cartels) had run their course by the 1980s
  – Some evidence that Wash Consensus worked (EOI countries)
  – But what are the deeper causes of economic growth?
    • Endowments
    • Institutions
    • Government policies (which are shaped by “interests”)

• Currency crises in the 1990s exposed problems with the Washington Consensus
  – Causes of currency crises
  – Anatomy of a crisis: Mexico 1994
Developing Countries Open Up to Trade

(average tariff rate, by region)
Developing Countries deregulate their financial markets and open up to int’l capital flows

Washington Consensus, more or less

Change in ‘openness’ (trade/GDP), 1977-97

Some developing countries expanded their global activity

Others increased their isolation from the world economy

• What can we learn by comparing the experiences of the two groups?
Convergence and divergence in the 1990s

GDP per capita growth rates, 1990s

Source: David Dollar and Art Kraay, “Trade, Growth, and Poverty.” 2001
Characteristics of globalized and less globalized nations

• More globalized countries started at lower average levels of income and schooling and ended up at higher average levels

• But what is the deep cause? Note that more globalized countries have better “Rule of Law.” Maybe this explains performance, not globalization

<table>
<thead>
<tr>
<th>Socioeconomic characteristics</th>
<th>More globalized (24)</th>
<th>Less globalized (49)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, 1997 (billions)</td>
<td>2.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Per capita GDP, 1980</td>
<td>$1,488</td>
<td>$1,947</td>
</tr>
<tr>
<td>Per capita GDP, 1997</td>
<td>$2,485</td>
<td>$2,133</td>
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<tr>
<td>Inflation, 1980 (percent)</td>
<td>16</td>
<td>17</td>
</tr>
<tr>
<td>Inflation, 1997 (percent)</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Rule of law index, 1997</td>
<td>-0.04</td>
<td>-0.48</td>
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<tr>
<td>(world average = 0)</td>
<td></td>
<td></td>
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<tr>
<td>Average years primary schooling, 1980</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Average years primary schooling, 1997</td>
<td>3.8</td>
<td>3.1</td>
</tr>
<tr>
<td>Average years secondary schooling, 1980</td>
<td>0.8</td>
<td>0.7</td>
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<tr>
<td>Average years secondary schooling, 1997</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Average years tertiary schooling, 1980</td>
<td>0.08</td>
<td>0.09</td>
</tr>
<tr>
<td>Average years tertiary schooling, 1997</td>
<td>0.18</td>
<td>0.22</td>
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What Causes Economic Growth?

• Is it …
  – **Factor endowments/geography** (resources, climate)?
    • Can have a **direct effect** on growth via agricultural productivity and morbidity (temperate zones vs. tropics)
    • Geography can also affect growth by way of openness (distance from markets)
  – **Institutions** (property rights, rule of law, individual liberties)?
    • “Good” institutions encourage investment and productivity – the engine of economic growth
    • “Bad” institutions discourage investment and productive activity (bad = insecure property rights, limits on economic and political liberties, etc)
  – **Government policies** (low inflation, openness to international trade, stable exchange rates)?
    • Governments may or may not pursue policies that encourage growth
What Causes Economic Growth?

• The answer seems to be “Institutions”
  – Countries with good policies but “poor” institutions have low incomes; those with poor policies but good institutions have high incomes

• What, in turn, causes good institutions?
  – Endowments/Geography have a strong historical influence on institutions
    • Factor endowments ⇒ institutions (Engermann and Sokoloff).
      – Factor endowments that engendered extreme inequalities three centuries ago (e.g. plantation economies), enabled a small group of elites to establish institutions that maintained their positions, but were harmful to growth

• High settler mortality during colonial period ⇒ poor institutions (Acemoglu, Johnson, and Robinson, 2002)
  – Where mortality was high (i.e. most of the tropics), settlers did not establish good institutions. Their goal was to extract resources quickly, and get out

• “Resource curse” ⇒ poor institutions (e.g. much of Africa)
  – Easy availability of natural resources (e.g. copper in Zambia) stunted institutional development. Why worry about protecting and promoting economic and political liberties when wealth can be dug from the ground?
Financial Crises in the 1990s

• Rash of currency crises in the 1990s signaled a “failure” of the Wash Consensus. What causes them?

• Traditional “Bad Policy” View
  – Misguided (politically expedient?) macroeconomic policies cause currency crises
    • Occur in context of fixed exchange rates
    • Fiscal laxity/inflation ⇒ overvaluation ⇒ FOREX intervention to defend currency ⇒ drain of int’l reserves ⇒ currency crisis ⇒ government forced to devalue or float

• New “Bad Policy” View
  – Poor financial regulation not macroeconomic policy the problem
    • Government bailout guarantees + lax regulation (or outright corruption) ⇒ moral hazard ⇒ excessive foreign borrowing to finance risky investments ⇒ crisis occurs when bank losses exceed government resources
Causes of Crises (cont.)

• The “Financial Panic” View
  – Maturity mismatch: many high-yield projects in developing countries (e.g., building a new factory) have long-term payoff. But much lending to developing countries is short-term. Things are stable so long as foreign investors keep rolling over short-term loans.
  – But like bank depositors, foreign investors know that a developing country cannot repay all its loans if investors all ask for repayment at once
  – Crises occur when some random event (e.g., bad news about exports) \( \Rightarrow \) loss of confidence \( \Rightarrow \) no new foreign loans \( \Rightarrow \) liquidity crisis (domestic banks must liquidate assets at “fire sale” prices to repay) \( \Rightarrow \) asset prices (stocks, real estate) collapse \( \Rightarrow \) runs on banks \( \Rightarrow \) “self-fulfilling” currency crisis \( \Rightarrow \) devaluation
Political Economy of a Crisis: Mexico 1994

• Background
  – Mexico/U.S. economic relationship
  – Debt Crisis of 1982
  – The “Lost Decade” (negative economic growth)
  – Structural Reforms and NAFTA

• Mexico’s Exchange-Rate Regime
  – Government uses the exchange-rate to stabilize inflation; the peso is fixed to the dollar in 1988.
  – In 1991, the crawling peg was replaced with a “Crawling Band” (Figure 1).
  – This fixed exchange rate system is the anchor for economic policy, i.e., the means to reduce inflation, discipline fiscal policy, and provide a more predictable climate for foreign investors.
Successes and Failures

- Until late 1994, Mexico's strategy of sound monetary and fiscal policies appeared to be having its intended effects.
  - Government spending was down.
  - Foreign capital investment was large.
  - Foreign exchange reserves were large (Figure 2)
  - Inflation had been steadily reduced – but not to US levels.

- The inflation differential with the U.S. meant that the peso was overvalued even with the slow, crawling devaluation.
  - This real appreciation of the peso, in turn, produced an ever growing current account deficit (Figure 3).
  - But foreign capital kept flowing in and no one was overly concerned with the current account imbalance…until late 1994.
Mexico Delays Adjustment

• Increasing tension between fiscal/monetary policies and the commitment to fixed exchange-rates. But no major changes

• **Politics** is key to understanding the delay
  – Presidential election
  – Assassination of a presidential candidate leads to a break in investor confidence and fall in int’l reserves
  – Despite raising interest rates, government cannot stem the run

• **Policy Options:**
  1. Raise interest rates (problem: upcoming election)
  2. Reduce gov’t expenditures to reduce domestic demand, decrease imports, and relieve pressure on the peso (problem: upcoming election)
  3. Devalue the peso (problem: upcoming election)

• **Actual Choice:** None of the above.
  – Gov’t chose to delay the day of reckoning until after the presidential election by issuing “tesobonos” (short-term gov’t debt indexed to the dollar)
Inconsistent Macroeconomic Policies

• Leading up to the presidential elections, Mexican authorities adopted policies that accommodated economic growth:
  - **Exchange rate policy**: No action was taken to correct for the real appreciation of the currency.
  - **Fiscal policy**: Instead of pursuing a policy of fiscal restraint, the Mexican government actually increased spending in 1994.
  - **Monetary policy**: Accommodated the economic expansion by keeping interest rates low.

• These policies increased the current account deficit while postponing action on the overvalued currency
  - Following the election, more political shocks (Chiapas uprising) led to renewed capital flight.
  - Foreign reserves declined to the point that authorities could no longer defend the established exchange rate through intervention.
  - The gov’t allowed the peso to float on 12/23/94
Figure 1: Mexico’s “Crawling Band” Exchange-Rate System, 1994

Exchange rate ceiling (buying pesos)

Exchange rate floor (selling pesos)

March 23: Colosio Assassination

Exchange rate band maintained through 12/19/94.
Figure 2: Mexico’s Foreign Exchange Reserves, July 1993 – Dec. 1994
Figure 3: Mexico’s Current Account Deficit, 1988-94
Figure 4: Political Economy of Devaluation

Possible policies to address problem

- Exchange rate policy
  - Discrete devaluation
  - Float the peso

- Monetary policy
  - Contractionary - tighten credit

- Fiscal policy
  - Contractionary - run budget surplus to decrease demand for imports
  - Postpone solution by financing current account deficit with short-term debt

Potential consequences

- Economic
  - Limited growth
  - Increased short-term debt

- Political
  - Potential loss of political support prior to the presidential election

- Accommodated economic growth
  - Stimulated economic expansion
  - Conversion of cetes to tesobonos

Actual policy action

- Maintained pegged exchange rate

Actual economic consequences

- Decrease in foreign reserves
- Current account deficit remained high
- Interest rates kept down
- Current account deficit remained high
- Current account deficit remained high
- Mexican government absorbed foreign exchange risk
- Dollar indexed short-term debt overhang
- Current account deficit remained high

Course of action taken by the Mexican government and resulting consequences

Possible policy actions and potential consequences
Figure 5: Peso – Dollar Exchange Rate, 1990-1998

Source: Haver Analytics