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Emerging Capital Markets in Turmoil: Bad Luck or Bad Policy?

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Abstract

Since the mid-1990s, emerging market economies have been hit by dramatic highs and lows: lifted by large capital inflows, then plunged into chaos by constrained credit and out-of-control exchange rates. The conventional wisdom about such crises is strongly influenced by the experience of advanced economies. In Emerging Capital Markets in Turmoil, Guillermo Calvo examines these issues instead from the perspective of emerging market economies themselves, taking into account the limitations and vulnerabilities these economies confront. A succession of crises -- Mexico in 1994-5, East Asia in 1997, Russia in 1998, and Argentina in 2001 -- prompted an urgent search in economic policy circles for cogent explanations. Calvo begins by laying the groundwork for a new approach to these issues. In the theoretical chapters that follow, he argues that financial crisis theory regarding emerging markets has progressed from focusing on such variables as fiscal deficits, debt sustainability, and real currency devaluation to stressing the role of the financial sector -- emphasizing stocks rather than flows as well as the role credibility plays in containing financial crises. He then returns to a more empirical analysis and focuses on exchange-rate issues, considering the advantages and disadvantages of flexible exchange rates for emerging market economies. Coming after a decade of ongoing crises, Calvo's timely reassessment of the importance of external factors in making emerging market economies safer from financial turmoil offers important policy lessons for dealing with inevitable future episodes of financial crises.

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