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Sequencing of reforms, financial globalization, and macroeconomic vulnerability ☆

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ABSTRACT

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I use a large cross country data set and panel probit analysis to investigate the way in which the interaction between trade and financial openness affect the probability of external crises. This analysis is related to debate on the adequate sequencing of reform. I also investigate the role played by current account and fiscal imbalances, contagion, international reserves holdings, and the exchange rate regime as possible determinants of external crises. The results indicate that relaxing capital controls increases the likelihood of a country experiencing a sudden stop. Moreover, the results suggest that "financial liberalization first" strategies increase the degree of vulnerability to external crises. This is particularly the case if this strategy is pursued with pegged exchange rates and if it results in large current account imbalances. *J. Japanese Int. Economies* **23** (2) (2009) 131–148. The Anderson School of Management, University of California, Los Angeles, CA, USA; National Bureau of Economic Research, Cambridge, MA, USA.

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1. Introduction

During the 1990s a large number of emerging and transition economies implemented profound market-oriented economic reforms. State owned enterprises were privatized, fiscal imbalances were tackled, trade barriers were lowered, and in many countries capital controls were eliminated. In the economic literature these economic policies are known, somewhat misleadingly, as the "Washington Consensus."[1]

During the early stages of this process a number of authors became concerned with the "sequencing of reform."[2] They argued that the order in which markets were deregulated mattered, and that liberalizing capital restrictions too early could be very costly. Many of these analysts were worried about the effects of a premature opening of the capital account on the (real) exchange rate and on international competitiveness. In particular, they pointed out that if restrictions on capital mobility were lifted "too soon," the country in question would be flooded with short term capital. This would result in an appreciation of the currency and reduce profitability in the exports' sector; in some countries it could also generate a short term real estate boom. The main danger, they argued, was that this increase in capital flows would be transitory, and that at some point foreign investors (and speculators) would withdraw from the country, generating a "sudden stop" and a costly crisis.

As the 1990s unfolded a growing number of policy makers dismissed this apprehensions about sequencing. Reforms were undertaken rapidly and almost simultaneously, and many countries relaxed capital controls during the early stages of the process. For some time this strategy seemed to work, as many countries experienced an acceleration in growth. In the second half of the 1990s and early 2000s, however, growth was replaced by a succession of deep and traumatic crises. In December 1994, the Mexican Peso collapsed and was devalued by more than 50%. In 1997, when the emerging world was beginning to recover from Mexico's "Tequila" crisis, the East Asian crises erupted, and it was followed by the Russian devaluation in 1998 and the failure of the investment firm *Long Term Capital Management*. In 1999 Brazil's real was devalued; in 2000 Turkey faced an external crisis; the Argentine peso collapsed in 2001, after 10 years of one-to-one parity with the U.S. dollar; and in 2002 Uruguay went through a deep balance of payments crisis. In many of these countries – as well as in those affected by "contagion" – output declined and unemployment increased significantly.

During the early 2000s, and partially as a result of these crises, an increasing number of analysts began to criticize the Washington Consensus and the market oriented reforms. Nobel laureate Joseph E. Stiglitz was, perhaps, the most forceful of the critics. In his 2002 book *Globalization and Its Discontent*, Stiglitz argues that globalization policies and market reforms have the potential of doing a lot of good, if undertaken properly and if they incorporate the characteristics of each individual country. The problem, according to Stiglitz, is that globalization was not pushed carefully or fairly. On the contrary, according to him, during the 1990s and early 2000s reform policies were implemented too fast, in the wrong sequence, and often using inadequate – or plainly wrong – economic analysis. Three interrelated policy issues were at the center of Stiglitz's and other criticisms of globalization and the Washington Consensus: (1) in designing reform packages during the 1990s, crucial aspects of the sequencing and pace of reform were ignored. As a result, in many countries reform was implemented too fast – Stiglitz prefers gradualism – and in the wrong order.[3] (2) Advocating (and imposing) financial liberalization was a huge mistake. According to Stiglitz freer capital mobility encourages speculation and increases the probability of external crises, including sudden stops of capital inflows. And (3), the IMF involvement in the East Asian and Argentinean crises was a disaster that made things worse rather than better.[4]

In this paper I use a large cross country data set to investigate whether, as posited by some authors, an increase in the degree of financial openness affects the likelihood that a country experiences

[1] See, for example, Williamson (1990) and Rodrik (2006).

[2] See Edwards (1990) and Funke (1993).

[3] Questions related to the sequencing of reform were first addressed by Mckinnon (1973). The subject was revived in the early 1980s by Edwards (1984). Both of these authors argued that the most adequate sequencing implied postponing the opening of the financial account.

[4] Criticism of the Washington Consensus can also be found in Rodrik (2006).