

AVOIDING FINANCIAL CRISES

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Course description

This course will focus on the causes of the most common financial crises that afflict developing and transition countries, with a view to understanding how best to avoid them altogether – or at least to minimize their destructive economic and political impact.

The episodes to be studied include monetary (inflation) crises, banking crises, currency (exchange rate) crises, and fiscal (debt) crises. The readings will cover mostly the empirical and policy-oriented literature, including specific case studies of crisis development, avoidance and resolution, drawing from experience in Asia, Emerging Europe and Latin America.

Our readings consist of the latest empirical and policy writings on the various topics – as opposed to theoretical papers or classic works from earlier years – and they are drawn from a variety of authors around the globe that are doing state-of-the-art research. The format is that of tutorial meetings in groups of 2 students, at an hour to be mutually agreed. The requirement is one paper every other week, for a total of 5 papers, to be delivered via e-mail (to Arturo.C.Porzecanski@williams.edu) by Wednesday 5PM before the Friday class during which the paper is to be discussed. The papers should make reference to the required readings but should go beyond a mere summary or critique of said readings, as per the suggestions provided in this syllabus. The prerequisite is Economics 509 and the enrollment limit is 10 students. Undergraduate enrollment is limited and only accepted with permission from the instructor.

Schedule and readings

February 4: Background on financial crises

Required readings:

- 1) Manuel Hinds, "Playing monopoly with the devil," forthcoming in International Finance, Vol. 8 #1, 2005.
- 2) Rudi Dornbusch, "A primer on emerging-market crises," in Sebastian Edwards and Jeffrey A. Frankel, editors, Preventing Currency Crises in Emerging Markets (Chicago: Chicago, 2002), pp. 743-754.

Supplementary readings:

- 1) Tuomas Komulainen and Johanna Lukkarila, "What drives financial crises in emerging markets?," Emerging Markets Review, Vol. 4 # 3, September 2003, pp. 248-272.
- 2) Barry Eichengreen, Financial Crises And What to Do About Them (New York: Oxford, 2002).
- 3) Michael Bordo et al., "Is the crisis problem growing more severe?," Economic Policy, Vol. 16 # 32, April 2001, pp. 53-82.

February 18: Monetary (inflation) crises, Part 1

Questions you may want to address in your paper: What is the nature of the inflation problem in your country, if any? What policy measures have been tried to lower inflation, and what has succeeded and what has failed? Is your country's experience comparable to that of any other country?

Required readings:

- 1) Stanley Fischer, Ratna Sahay and Carlos Végh, "Modern hyper- and high inflations," Journal of Economic Literature, Vol. XL # 3, September 2002, pp. 837-880.
- 2) David Burton and Stanley Fisher, "Ending moderate inflations," in Stanley Fischer, IMF Essays from a Time of Crisis (Cambridge, MA: MIT, 2004), pp. 327-382.

Supplementary readings:

- 1) Prakash Loungani and Phillip Swagel, "Sources of inflation in developing countries," in Elhanan Helpman and Efraim Sadka, editors, Economic Policy in the International Economy: Essays in Honor of Assaf Razin (Cambridge: Cambridge, 2003), pp. 207-230.
- 2) William Easterly and Stanley Fischer, "Inflation and the poor," in IMF Essays..., op. cit., pp. 461-484.
- 3) Javier Hamann and Alessandro Prati, "Why do many disinflations fail? The importance of luck, timing, and political institutions," IMF Working Paper WP/02/228, December 2002, in www.imf.org/external/pubs/ft/wp/2002/wp02228.pdf
- 4) Oya Celasun, R. Gaston Gelos and Alessandro Prati, "Obstacles to disinflation: what is the role of fiscal expectations?," IMF Working Paper WP/04/111, June 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04111.pdf
- 5) John F. Boschen and Charles L. Weise, "What starts inflation: evidence from the OECD countries," Journal of Money, Credit, and Banking, Vol. 35 #3, June 2003, pp. 323-349.
- 6) Javier Andrés, Ignacio Hernando and J. David López-Salido, "Assessing the benefits of price stability: the international experience," in Banco de España Economic Studies #69, 1999, in www.bde.es/informes/be/sazul/azul69e.pdf
- 7) Charles Goodhart and Gerhard Illing, editors, Financial Crises, Contagion, and the Lender of Last Resort (New York: Oxford, 2002).

- 8) Michael Bruno et al., editors, Lessons of Economic Stabilization and Its Aftermath (Cambridge, MA: MIT, 1991).
- 9) Michael Bruno et al., editors, Inflation Stabilization: The Experience of Israel, Argentina, Brazil, Bolivia and Mexico (Cambridge, MA: MIT, 1988).

February 25: Monetary (inflation) crises, Part 2

Questions you may want to address in your paper: How does your country's central bank operate, and how able is it to control inflation in theory and in practice? Has an inflation targeting framework been adopted, and if so how is it working? If not, why not and do you think it should be adopted?

Required readings:

- 1) Frederic S. Mishkin, "Can inflation targeting work in emerging market countries?," NBER Working Paper #10646, July 2004, in www.nber.org/papers/w10646.pdf
- 2) Alina Carare et al., "Establishing initial conditions in support of inflation targeting," in Piero C. Ugolini et al., editors, Challenges to Central Banking from Globalized Financial Systems (Washington, DC: IMF, 2003), pp. 151-190.

Supplementary readings:

- 1) Mark R. Stone, "Inflation targeting lite," in Challenges to Central Banking, op. cit., pp. 111-141.
- 2) Arminio Fraga, Ilan Goldfajn and André Minella, "Inflation targeting in emerging market economies," in Mark Gertler and Kenneth Rogoff, editors, NBER Macroeconomics Annual 2003 (Cambridge, MA: MIT, 2004), pp. 365-400.
- 3) Edwin M. Truman, Inflation Targeting in the World Economy (Washington, DC: IIE, 2003).
- 4) Eduardo Morón and Diego Winkelried, "Monetary policy rules for financially vulnerable economies," IMF Working Paper WP/03/39, February 2003, in www.imf.org/external/pubs/ft/wp/2003/wp0339.pdf
- 5) M. S. Mohanty and Marc Klau, "Monetary policy rules in emerging market economies: issues and evidence," BIS Working Papers #149, March 2004, in www.bis.org/publ/work149.pdf
- 6) Claudio Borio and Philip Lowe, "Securing sustainable price stability: should credit come back from the wilderness?," BIS Working Papers #157, July 2004, in www.bis.org/publ/work157.pdf
- 7) Mario I. Blejer et al., editors, Inflation Targeting in Practice: Strategic and Operational Issues and Applications to Emerging Market Economies (Washington, DC: IMF, 2000).
- 8) Ben S. Bernanke et al., editors, Inflation Targeting: Lessons from the International Experience (Princeton, NJ: Princeton, 1999).
- 9) BIS, "The transmission of monetary policy in emerging market economies," BIS Policy Papers #3, January 1998, in www.bis.org/publ/plcy03.pdf

March 4: Banking crises, Part 1

Questions you may want to address in your paper: Has your country suffered from a major banking crisis and, if so, did it follow the usual pattern? If you have not experienced such a crisis, why do you think that is?

Required readings:

- 1) Inter-American Development Bank, "Determinants and characteristics of banking crises," in Unlocking Credit: The Quest for Deep and Stable Bank Lending (Washington, DC: IADB, 2004), pp. 29-48.
- 2) Barry Eichengreen and Carlos Arteta, "Banking crises in emerging markets: presumptions and evidence," in Mario I. Blejer and Marko Skreb, editors, Financial Policies in Emerging Markets (Cambridge, MA: MIT, 2002), pp. 47-94.

Supplementary readings:

- 1) David S. Hoelscher et al., "Managing systemic banking crises," IMF Occasional Paper #224 (Washington, DC: IMF, 2003).
- 2) Alicia Garcóa Herrero and Pedro del Río, "Financial stability and the design of monetary policy," in Banco de España Working Paper #315, 2003, in www.bde.es/informes/be/docs/dt0315e.pdf
- 3) Ilan Noy, "Financial liberalization, prudential supervision, and the onset of banking crises," Emerging Markets Review, Vol. 5 #3, 2004, pp. 341-359.
- 4) James Bell and Darren Pain, "Leading indicator models of banking crises: a critical review," Bank of England Financial Stability Review, #9, December 2000, pp. 113-129, in www.bankofengland.co.uk/fsr/fsr09art3.pdf
- 5) Carlos O. Arteta, "Are financially dollarized countries more prone to costly crises?," Federal Reserve Board International Finance Discussion Papers #763, March 2003, in www.federalreserve.gov/pubs/ifdp/2003/763/ifdp763.pdf
- 6) Anne-Marie Gulde et al., "Financial stability in dollarized economies," IMF Occasional Paper #230 (Washington, DC: IMF, 2004).
- 7) Haizhou Huang, Dalia Marin and Chenggang Xu, "Financial crisis, economic recovery, and banking development in Russia, Ukraine and other FSU countries," IMF Working Paper WP/04/105, June 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04105.pdf
- 8) Charles Collyns and G. Russell Kincaid, "Managing financial crises: recent experience and lessons for Latin America," IMF Occasional Paper #217 (Washington, DC: IMF, 2003).

March 11: Banking crises, Part 2

Questions you may want to address in your paper: How strong or weak are the bank regulatory and supervisory institutions in your country? What do you think about the bank deposit insurance system, if there is one? Are foreign banks active in your country and, if not, do you think they should be invited in to provide more systemic stability and competition?

Required readings:

- 1) Frederic S. Mishkin, "Financial policies and the prevention of financial crises in emerging market countries," in Martin Feldstein, editor, Economic and Financial Crises in Emerging Market Economies (Chicago: Univ. of Chicago Press, 2003), pp. 93-130.
- 2) Aristóbulo de Juan, "From good bankers to bad bankers," in Gerard Caprio, Patrick Honohan and Dimitri Vittas, editors, Financial Sector Policy for Developing Countries (Washington, DC: World Bank, 2002), pp. 19-30.

Supplementary readings:

- 1) James R. Barth, Gerard Caprio Jr. and Ross Levine, "Bank regulation and supervision: what works best?," Journal of Financial Intermediation, Vol. 13 #2, April 2004, pp. 205-248.
- 2) David G. Mayes, "Who pays for bank insolvency?," Journal of International Money and Finance, Vol. 23 #3, April 2004, pp. 515-551.
- 3) Matthew T. Jones, Paul Hilbers and Graham Slack, "Stress testing financial systems: what to do when the Governor calls," IMF Working Paper WP/04/127, July 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04111.pdf
- 3) David C. Cole, "Impact of early financial growth strategies on financial structures and problems in three Asian crisis countries," in Financial Sector Policy..., op. cit., pp. 31-47.
- 4) Enrica Detragiache and Poonam Gupta, "Foreign banks in emerging market crises: evidence from Malaysia," IMF Working Paper WP/04/129, July 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04129.pdf
- 5) Kam Hon Chu, "Deposit insurance and banking crises in the short and long run," Cato Journal, Vol. 23 #2, Fall 2003, pp. 265-280, in www.cato.org/pubs/journal/cj23n2/cj23n2-8.pdf
- 6) Aerd Houben, Jan Kakes and Garry Schinasi, "Toward a framework for safeguarding financial stability," IMF Working Paper WP/04/101, June 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04101.pdf
- 7) Gerard Caprio Jr. et al., editors, Preventing Bank Crises: Lessons from Recent Global Bank Failures (Washington, DC: World Bank, 1998).

April 8: Currency (exchange rate) crises, Part 1

Questions you may want to address in your paper: Has your country suffered from a major exchange rate crisis and, if so, did it follow the usual pattern? If you have not experienced such a crisis, why do you think that is?

Required readings:

- 1) Ilker Domac, Maria Soledad Martinez Peria, "Banking crises and exchange rate regimes: is there a link?," Journal of International Economics, Vol. 61, 2003, pp. 41-72.
- 2) Steven A. Block, "Political conditions and currency crises in emerging markets," Emerging Markets Review, Vol. 4 # 3, September 2003, pp. 287-309.

- 3) Evan Tanner, "Exchange market pressure, currency crises, and monetary policy: additional evidence from emerging markets," IMF Working Paper WP/02/14, January 2002, in www.imf.org/external/pubs/ft/wp/2002/wp0214.pdf

Supplementary readings:

- 1) Poonam Gupta, Deepak Mishra and Ratna Sahay, "Output response to currency crises," IMF Working Paper WP/03/230, November 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03230.pdf
- 2) Michael P. Dooley and Jeffrey A. Frankel, editors, Managing Currency Crises in Emerging Markets (Chicago: Chicago, 2003).
- 3) Manmohan Kumar, Uma Moorthy and William Perraudin, "Predicting emerging market currency crashes," IMF Working Paper WP/02/7, January 2002, in www.imf.org/external/pubs/ft/wp/2002/wp0207.pdf
- 4) Swati Ghosh and Atish Ghosh, "Structural vulnerabilities and currency crises," IMF Working Paper WP/02/9, January 2002, in www.imf.org/external/pubs/ft/wp/2002/wp0209.pdf
- 5) Sebastian Edwards and Jeffrey A. Frankel, editors, Preventing Currency Crises in Emerging Markets (Chicago: Chicago, 2002).
- 6) Stijn Claessens and Kristin J. Forbes, editors, International Financial Contagion (Boston: Kluwer, 2001).
- 7) Paul Krugman, editor, Currency Crises (Chicago: Chicago, 2000).

April 15: Currency (exchange rate) crises, Part 2

Questions you may want to address in your paper: What has been your country's experience with various exchange-rate regimes? Do you think that you would be better off with a more flexible, market-based currency regime; with a more fixed exchange rate; or with no national currency at all (e.g., dollarization or euroization)?

Required readings:

- 1) Stanley Fischer, "Exchange rate regimes: is the bipolar view correct?," in IMF Essays..., op. cit., pp. 227-254.
- 2) Andrea Bubula and Inci Otker-Robe, "Are pegged and intermediate exchange rate regimes more crisis prone?," IMF Working Paper WP/03/223, November 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03223.pdf
- 3) Guillermo Calvo and Frederic Mishkin, "The mirage of exchange-rate regimes for emerging-market countries," Journal of Economic Perspectives, Fall 2003, pp. 99-118.

Supplementary readings:

- 1) Rupa Duttgupta, Gilda Fernandez and Cem Karacadag, "From fixed to float: operational aspects of moving toward exchange rate flexibility," IMF Working Paper WP/04/126, July 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04126.pdf

- 2) Ari Aisen, "Money-based versus exchange-rate based stabilization: is there space for political opportunism?," IMF Working Paper WP/04/94, June 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0494.pdf
- 3) Eduardo Levy-Yeyati and Federico Sturzenegger, "To float or to fix: evidence on the impact of exchange rate regimes on growth," American Economic Review, Vol. 93 #4, September 2003, pp. 1173-1193.
- 4) BIS, "Regional currency areas and the use of foreign currencies," BIS Papers #17, September 2003, in www.bis.org/publ/bispap17.pdf
- 5) Rupa Duttagupta and Inci Otker-Robe, "Exits from pegged regimes: an empirical analysis," IMF Working Paper WP/03/147, July 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03147.pdf
- 6) Alberto Alesina and Alexander Wagner, "Choosing (and reneging on) exchange rate regimes," NBER Working Paper #9809, June 2003, in www.nber.org/papers/w9809.pdf
- 7) Corinne Ho and Robert N. McCauley, "Living with flexible exchange rates: issues and recent experience in inflation targeting emerging market economies," BIS Working Papers #130, February 2003, in www.bis.org/publ/work130.pdf
- 8) Felipe Larraín and Andrés Velasco, "How should emerging economies float their currencies?," Economics of Transition, Vol. 10 #2, 2002, pp. 365-392.
- 9) Kenneth S. Rogoff et al., "Evolution and performance of exchange rate regimes," IMF Occasional Paper #229, 2004.

April 22: Currency (exchange rate) crises, Part 3

Questions you may want to address in your paper: Are currency and other mismatches prevalent in your country, and if so why or why not? What do you think should be done to minimize these mismatches, or to prevent their negative consequences?

Required readings:

Morris Goldstein and Philip Turner, Controlling Currency Mismatches in Emerging Markets (Washington, DC: IIE, 2004), pp.1-120.

Supplementary readings:

- 1) Barry Eichengreen, Ricardo Hausmann and Ugo Panizza, "Currency mismatches, debt intolerance and original sin: why they are not the same and why it matters," NBER Working Paper #10036, October 2003, in www.nber.org/papers/w10036.pdf
- 2) Ricardo Hausmann, "Good credit ratios, bad credit ratings: the role of debt structure," in George Kopits, editor, Rules-Based Fiscal Policy in Emerging Markets (New York: Palgrave MacMillan, 2004), pp. 30-52.
- 3) Adolfo Barajas and R. Armando Morales, "Dollarization of liabilities: beyond the usual suspects," IMF Working Paper WP/03/11, January 2003, in www.imf.org/external/pubs/ft/wp/2003/wp0311.pdf

- 4) Mark Allen et al., "A balance sheet approach to financial crisis," IMF Working Paper WP/02/210, December 2002, in www.imf.org/external/pubs/ft/wp/2002/wp02210.pdf

April 29: Currency (exchange rate) crises, Part 4

Questions you may want to address in your paper: How widespread is spontaneous dollarization in your country, and do you think it is good or bad? Should this dollarization be encouraged or discouraged – or merely ignored?

Required readings:

- 1) Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano, "Addicted to dollars," NBER Working Paper #10015, October 2003, in www.nber.org/papers/w10015.pdf
- 2) Gianni De Nicoló et al., "Dollarization of the banking system: good or bad?" IMF Working Paper WP/03/146, July 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03146.pdf

Supplementary readings:

- 1) Mario de Zamaróczy and Sopenha Sa, "Economic policy in a highly dollarized economy: the case of Cambodia," IMF Occasional Paper #219, 2003.
- 2) Sebastian Edwards and I. Igal Magendzo, "Strict dollarization and economic performance: an empirical investigation," NBER Working Paper #9820, July 2003 in www.nber.org/papers/w9820
- 3) Andrew Berg and Eduardo Borensztein, "The pros and cons of full dollarization," in Dominick Salvatore et al., editors, The Dollarization Debate (New York: Oxford, 2003), pp. 72-101.
- 4) Eduardo Levy Yeyati and Federico Sturzenegger, "Dollarization: a primer," in Dollarization (Cambridge, MA: MIT, 2003), pp. 1-51.

May 6: Fiscal (debt) crises, Part 1

Questions you may want to address in your paper: Is your country "debt intolerant," and if so why or why not? Do you think that its external debt burden is sustainable, and if so why or why not? What are the policy implications of your assessment?

Required readings:

- 1) Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano, "Debt intolerance," Brookings Papers on Economic Activity, #1, Spring 2003, pp. 1-74.
- 2) Aart Kraay and Vikram Nehru, "When is external debt sustainable?," draft, October 2003, in www.imf.org/external/np/res/seminars/2003/lic/pdf/kn.pdf

Supplementary readings:

- 1) Craig Burnside, editor, Fiscal Sustainability in Theory and Practice: A Handbook (Washington, DC: World Bank, 2004).

- 2) IMF and World Bank, "Debt sustainability in low-income countries: proposal for an operational framework and policy implications," draft, February 3, 2004, in www.imf.org/external/np/pdr/sustain/2004/020304.pdf
- 3) IMF, "Public debt in emerging markets: is it too high?," World Economic Outlook September 2003, pp. 113-152, in www.imf.org/external/pubs/ft/weo/2003/02/pdf/chapter3.pdf
- 4) Thomas Helbling, Ashoka Mody and Ratna Sahay, "Debt accumulation in the CIS-7 countries: bad luck, bad policies, or bad advice?," IMF Working Paper WP/04/93, May 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0493.pdf
- 5) Richard Hemming, Michael Kell and Axel Schimmelpfennig, "Fiscal vulnerability and financial crises in emerging market economies," IMF Occasional Paper #218, 2003.
- 6) Shogo Ishii et al., "Capital account liberalization and financial sector stability," IMF Occasional Paper #211, 2002.
- 7) IMF, "Access to international capital markets for first-time sovereign issuers," and "Country cases," draft, November 17, 2003, in www.imf.org/external/np/icm/2003/eng/111703.pdf and www.imf.org/external/np/icm/2003/eng/111703s1.pdf

May 13: Fiscal (debt) crises, Part 2

Questions you may want to address in your paper: Has your government defaulted on its external debt, and if so why or why not? Do you think that your country needs debt forgiveness, and if so how should it go about getting it? What are the policy implications of your assessment?

Required readings:

- 1) Punam Chohan and Federico Sturzenegger, "Default episodes in the 1980s and 1990s: what have we learned?," March 2004, in www1.worldbank.org/economicpolicy/documents/mv/pgchapter08.pdf
- 2) Arturo C. Porzecanski, "Dealing with sovereign debt: trends and implications," forthcoming in Chris Jochnick and Fraser Preston, editors, Sovereign Debt at the Crossroads (New York: Oxford Univ. Press, 2005).

Supplementary readings:

- 1) Guillermo A. Calvo, Alejandro Izquierdo and Ernesto Talvi, "Sudden stops, the real exchange rate, and fiscal sustainability: Argentina's lessons," in Monetary Unions and Hard Pegs: Effects on Trade, Financial Development, and Stability, Volbert Alexander et al., editors (New York: Oxford, 2004), pp. 151-181.
- 2) Caroline Van Rijckeghem and Beatrice Weder, "The politics of debt crises," CEPR Discussion Paper #4683, October 2004, in www.cepr.org/pubs/dps/DP4683.asp
- 3) Mark Kruger and Miguel Messmacher, "Sovereign debt defaults and financing needs," IMF Working Paper WP/04/53, March 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0453.pdf

- 4) Andrea Pescatori and Amadou N. R. Sy, "Debt crises and the development of international capital markets," IMF Working Paper WP/04/44, March 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0444.pdf
- 5) Nouriel Roubini and Brad Setser, Bailouts or Bail-ins: Responding to Financial Crises in Emerging Economies (Washington, DC: IIE, 2004).
- 6) Barry Eichengreen, "Restructuring sovereign debt," Journal of Economic Perspectives, Vol. 17 #4, Fall 2003, pp. 75-98.
- 7) Lex Rieffel, Restructuring Sovereign Debt: The Case for Ad Hoc Machinery (Washington, DC: Brookings, 2003).
- 8) IMF, "Guidelines for public debt management," draft December 9, 2003, in www.imf.org/external/np/mfd/pdebt/2003/eng/am/120903.pdf and "Country case studies," draft August 4, 2003, in www.imf.org/external/pubs/ft/pdm/eng/guide/pdf/part2.pdf