

EDITORIAL INTRODUCTION

REFİK ERZAN
Boğaziçi University

As an economist involved in development matters over the last two decades, I believed and preached that, in most issues, it was primarily the developing countries themselves that had to take the blame for their own poor performance. There were opportunities and dangers. Seize the opportunity, avoid the danger! I strongly argued for more trade and more foreign direct investment since there were major gains to be made. This was not a zero sum game.

In short term capital movements, I maintained the same spirit when I organized the 1999 macroeconomics conference of the Center for Economics and Econometrics (CEE). Not a zero sum game, seize the opportunity, avoid the danger.

Since the conference in July 1999, while the volume was in preparation, I developed some doubts that short term capital movements may in fact allow or lead to zero sum – or worse – negative sum games. Nevertheless, the title is appropriate: "Learning to Live with Volatile Capital Movements and Contagion".

A very positive development since the conference was Turkey's stabilization program which was launched in December 1999. Its success will be the best medicine to reduce Turkey's vulnerability in this respect, as Cevdet Akçay and Murat Üçer point out in their paper.

Except opinions expressed by Yılmaz Akyüz, the Chief Economist of United Nations Conference on Trade and Development (UNTAD), the working assumption in the research undertaken for the conference and the papers presented was free movement of capital.

The opening lecture was given by Jim Healy, the Head of Emerging Markets Fixed Income Group at Credit Suisse-First Boston (CSFB). Healy looked at contagion from the market perspective. His observations underlined an inherent instability in international capital markets.

Healy laid out the facts associated with the three recent crises - Mexico, Asia, and Russia - from a contagion perspective and discussed one particular channel of contagion - "forced liquidation"- that he felt was particularly relevant in explaining the global contagion that arose in the aftermath of the Russian crisis.

Through a graphical examination of the behavior in major traded markets (fixed income, equity, and currency), Healy observed that: (a) regional contagion was fairly strong in bond and equity markets during all three crises, but in the case of exchange rates, contagion was strong only during the Asian crisis; and (b) global contagion was less frequent than regional contagion, and that only the Russian crisis exhibited strong global contagion. As to why regional contagions did not turn into global contagions in the Mexican and Asian cases, Healy suggested that the role of policy (namely IMF packages) would have to be factored in.

As a general pattern, Healy observed that contagion effects were generally short-lived, i.e. they dissipated after a few weeks and that recovery in the infected countries would occur over several months. He then raised an interesting question, partly inspired by the efficient markets hypothesis: if post-crises patterns were so typical and predictable, why would the contagion effects be observed in the first place? Investors would see a crisis coming, but because they knew that these crises would follow a typical pattern (collapse and then recover in a few months), they would not have the incentive to get out.

In this connection, Healy referred to the academic literature, in particular a recent article by Andrei Schleifer and Robert Vishny, "The Limits of Arbitrage". The Schleifer-Vishny model, based on two types of agents - "noise traders" who traded over sentiment and "arbitrageurs" that traded on the basis of the true model (or fundamentals). This was a circumstance in which, contrary to their traditional roles, arbitrageurs could be the cause for volatility (as had been the proprietary traders such as Long-term Capital, CSFB, and the likes during the Russian crisis) simply because the unavailability of credit, such as the unwillingness by creditors to roll over their repos with these "hedge funds", forced them to liquidate. In sum, Healy suggested "forced liquidation", which involves the drying up of credit in a leveraged world with "arbitrageurs" having been forced to do what their investors want them to do, as a particularly relevant channel of contagion.

Yılmaz Akyüz, the Chief Economist of UNCTAD, summarized what he considered "the issues in the reform of the global financial architecture". Accordingly, given the inherent instability of international capital movements, any country that is closely integrated into the global financial system is susceptible to currency turmoil and financial crisis even when it adopts the best standards for information disclosure, prudential regulations and supervision, and regardless of the exchange rate regime it pursues. Developing countries, in view of their dependence on foreign capital and their net external indebtedness are particularly vulnerable. Thus, according to Akyüz, global financial reform is an issue deserving top priority for them. Global arrangements designed for the prevention and management of financial instability would include some combination of disclosure and transparency by both public and private institutions; effective surveillance over national macroeconomic and financial policies; globally agreed upon, but nationally implemented, rules for the control of capital flows through oversight by international lenders and borrowers, and multinational financial firms; a genuine international lender of last resort with the discretion to create its own liquidity; and orderly debt work-out procedures to prevent an asset grab race, in order to provide current account financing and restructuring

of debt. However, given the reluctance of the industrialized countries to accommodate the concerns of developing countries, Akyüz concluded that, in the current political environment, the maximum feasible strategy for developing countries in their search for greater financial stability over the near term would seem to be to try to combine national control over capital flows with some internationally agreed upon arrangements for debt standstills and lending into arrears.

The paper by Cevdet Akçay and Murat Üçer explored the role of macro policy in coping with contagion, with particular emphasis on the experiences of Turkey. Sound macro policies, a healthy banking sector, and transparency are all key to reducing vulnerability to contagion. Short of those, there is very little that the policy-maker can do once contagion hits, except perhaps a host of credible policy announcements and an active use of interest rate policy. They observed that imposing restrictions on capital flows have become fashionable advice, but ruled them impractical, and somewhat ill conceived. Their advice for survival was: stay liquid, i.e. carry high levels of international reserves compared to short-term liabilities and avoid overvaluation. Akçay and Üçer observed that, that was what Turkey was trying to do. But, they concluded that this policy cannot be sustained indefinitely since it cost a huge payment of "risk premium." A strong, well-designed, and well-articulated disinflation program, hence a stable currency, was their way out of this dilemma.

The paper by Cevdet Akçay, Refik Erzan and Ünal Zenginobuz considered the issue of policy interdependence among emerging countries which have recently been subject to contemporaneous financial crises that spread from one emerging market to the other. Taking contagion of adverse movements in one emerging financial market to others as a given fact, the paper asked whether there was a need for policy coordination among emerging countries to ameliorate the ill effects of contagion. In this context, the role of interdependence of expectations formed by international investors regarding the performance of emerging markets was examined. The paper concentrated on the case of pure contagion whereby a crisis might arise in an emerging market with 'sound' fundamentals solely because of an actual or impending crisis in another emerging market. The question was what actions taken jointly by authorities in emerging markets might lead to a more accurate and stable formation of expectations by international investors regarding their economic and financial performance?

Kamil Yılmaz studied the impact of financial globalization on stock market volatility in each country, and the contagion of volatility that might ensue across markets. His paper analyzes volatility contagion across 19 major developed and emerging stock markets around the world in the 1990s. It was observed that in the second half of the 1990s, volatility in developed and emerging markets increased substantially. Contemporaneous return and volatility correlations across stock markets increased during the same period as well. An attempt was made to differentiate between persistent and temporary stock return volatility, as well as between an idiosyncratic increase in volatility and volatility contagion effect from other markets. It was shown that the Russian crisis led to more volatility contagion than the East Asian crisis, because developed markets, such as the NYSE and the London Stock Exchange, were directly affected by the Russian crisis. The Russian crisis led to persistent volatility in these markets because American and

European banks and investment funds lost billions of dollars when the Russian government declared a moratorium on its debt and stock prices on the Moscow stock exchange went down drastically. Once these markets were hit, they carried the contagion to other parts of the world.

Emre Alper and İsmail Sağlam investigated the impact of the 1994 domestic financial crisis and the Mexican, East Asian and Russian financial crises on the real side of the Turkish economy. The first question addressed was the existence and magnitude of contraction in the real sector following the four financial crises. Then, the channels through which the financial shock was transmitted onto the real variables was examined. It was observed that not all financial crises and sudden capital outflows affected the Turkish economy alike.

Research behind the conference benefited from work undertaken by several graduate students. Two of these background papers are included in this conference volume.

Baybars Karacaovalı analyzed the determinants of contagious currency and financial crises in the aftermath of the Asian 1997 experience. The commonly identified factors that increase vulnerability to currency and financial crises were an appreciated real exchange rate, heavy lending in the private sector and low levels of foreign exchange reserves in proportion to a government's liabilities as measured by broad money. Karacaovalı claimed that these vulnerability indicators speed up the downgrading of a country at the instance of a shock and the process results in serious capital outflows for the country under concern. The initial shock in this case was the devaluation of the Thai Baht in July 1997. How this shock spread among certain countries but not in others was examined.

Fatma Karapaşaoğlu's paper aims to discover the effects of the changes in monetary aggregates on macro variables (output, price level, exchange rate, interest rate and consumption) in Turkey. The focus is on the distinction between the effects of anticipated versus unanticipated changes in monetary policy.

I have, again, accrued a lot of indebtedness in connection with the conference and this volume. The research behind the papers could not have been possible without financial support from CSFB. Murat Üçer and Bunt Ghosh have been instrumental in this matter. The list of people that helped the organization and the publication is a long one. The patience awards go to Korcan Demircioğlu, Murat Erim and Kadem Şenkal. I am grateful to all of them.

REFERENCE

Schleifer, A., Vishny R. (1997). "The Limits of Arbitrage," *Journal of Finance*, Vol. 52, No.1 (March), pp 35-55.