

Week 6: International Finance. Krugman, Paul. 1995. “Dutch Tulips and Emerging Markets.” Foreign Affairs. July/August. pp. 28-44.

Sorry for an unfriendly length, but you know Krugman, and this is a good piece on financial crisis. Though mainly about the Mexican peso crisis, a lot of the logic is helpful in understanding the Asian crisis – in case you are vaguely interested in the stuff.

Main question: Is Washington Consensus an appropriate course for developing countries to follow? Also he tries to explain why governments eagerly adopted the consensus and why markets enthusiastically poured funds into reforming economies? How did the Mexican crisis occur?

Main explanation: No. The consensus became highly discredited after the crisis in Mexico, who was widely regarded as a model for the consensus. Krugman argues that the Mexican crisis was an accident waiting to happen because the stunning initial success of the Washington consensus in Mexico was based not on solid achievements, but on excessively optimistic expectations. It is not that policy recommendations are wrong (whether they are appropriate for each country is a separate discussion). The initial success after the implementation was a result of not only the usual economic process by which excessive market optimism can be a temporarily self-fulfilling prophecy, but also a more subtle political process through which the common beliefs of policymakers and investors proved mutually reinforcing. He projects that the Mexican crisis was the beginning of the deflation of the consensus and a more problematic period of the second half of 1990s. For the second part of the question, the answer is speculative bubble or false optimism. Once such optimism erodes, crisis begins.

What is the Washington consensus? It reflects views believed by institutions and networks of policy leaders in Washington, DC such as the IMF, the World Bank, think tanks, investment bankers, and finance ministers worldwide. The essence of the ten points in the consensus is that free markets and sound money is the key to economic development. The consensus has been widely accepted among technocrats both in DC and in developing countries as an appropriate course to develop their economies.

Why does Krugman disagree with the consensus? He calls it ‘reality check’ – whether the consensus was successful due to over-optimism, but in fact the consensus would not necessarily be effective in all cases. He discusses the consensus in two aspects: free trade and sound money.

1) Free Trade. He points out the dirty little secret in international economics. The measurable costs of protectionist policies i.e. the reduction in real income that can be attributed to tariffs and import quotas are not as large as the hype makes it seem. Moreover, the empirical evidence for huge gains from free market policies is still fuzzy. One cannot say for certain about the large gains from trade liberalization. The bottom line in this part is that the “widespread belief that moving to free trade and free markets will produce a dramatic acceleration in a developing country’s growth represents a leap of faith, rather than a conclusion based on hard evidence (33).”

2) Sound money. The arguments used by the consensus are even weaker in this case than in the free trade case. Admittedly, very high inflations disrupt the economies, but it is difficult to pin down any large gains from a reduction in the inflation rate. A recommendation to use pegged exchange rate to build credibility (especially after a long period of high inflation) has serious costs. A country that tries to end inflation by establishing a fixed exchange rate almost always finds that the momentum of inflation continues for a considerable time and domestic prices will end up out of the line with the rest of the world – usually overvalued once the inflation actually subsides. Exchange rate also becomes difficult to sustain once market conditions change such as an increase in oil price.

Krugman then concludes that the progress seen in countries adopting the Washington consensus in 1990s resulted merely from self-enforcing optimism. He tries to make a case that the enthusiasm apparent in

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both governments and markets are merely speculative bubbles. It is a political economy cycle: “governments were persuaded to adopt Washington consensus policies because markets so spectacularly rewarded them, and in which markets were willing to supply so much capital because they thought they saw an unstoppable move toward policy reform (36).”

Another small puzzle is why did the economic crisis in Latin America not end up in more protectionism? This is because reformers in those countries were able to bundle free trade in a package and promoted the package as yielding large gains to the economy as a whole. Moreover, the government does not have to undertake every policy in the package. As long as a program of stabilization-cum-liberalization seems to work, the political process is easily persuaded that all of the package is essential. And the package works, not because of the policy merits, but because of the sudden improvement in investor confidence seeing that the country is adopting the package – political economy cycle.

Why would the package not work in reality? Again because it was all the hype of Latin American countries adopting the consensus, which would not necessarily work. And it didn't because of three reasons. (This is quite amazing because it was actually what happened to Asia two years later as well.)

- 1) While hard currency policies brought down inflation, they did so only gradually. As a result, prices got far out of line with those in the rest of the world. In other words, the exchange rates did not keep up with rapidly rising inflations. The result was an appreciation of real exchange rate (ratio of Mexican prices in dollars to American prices in the US)– less competitiveness in the world market.
- 2) In spite of huge inflows of foreign capital, the real growth in the recipient economies was generally disappointing.
- 3) the benefits of growth were not evenly distributed.

Given this reality, any crisis of confidence could easily trigger a crisis. In fact, markets started losing confidence in Mexico in 1994 as it became less competitive (due to rising real exchange rate). Also, it became more apparent that the free market policies adopted by the government did not generate any impressive growth. The government had a dilemma whether to depreciate the peso to regain competitiveness, but to do so would damage its credibility in adhering to sound money policy in the consensus. The market certainly smelled this, so they slowed down much-needed financial flows into Mexico. The same logic of a crisis applies: “investors hold less peso assets unless offered very high interest rates; and the necessity of paying these high rates, together with the depressing effect of high rates on the economy, increased the pressure on the government to abandon the fixed exchange rate – which made investors even less willing to hold pesos (42).” Mexico would inevitably be plunged into crisis anyway with or without the political crisis.

Conclusion: Krugman concludes that the rest of the decade (from 1995) would be about deflating expectations and markets would no longer pour vast amounts of capital into countries whose leaders espouse free markets and sound money on the assumption that such policies will necessarily produce vigorous growth; they will want hard evidence. This was not quite right. Look at the capital flows into Asia between 1995 and 1997, which contradicts Krugman's prediction. Krugman argues that some countries might even adopt capital controls to stop capital flight (sounds familiar?). Another question is whether the consensus is the only way to go. Krugman hints that there are other models than the American available to emulate such as the Japanese. Though the intellectual basis for adopting the Japanese model is quite weak, history tells that you never know.