Comments on Paper 3

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Professors Aizenman and Hutchison tackle an important and intriguing set of questions: How did the financial crisis that started from a U.S. real estate bubble transmit into a global crisis that affected virtually every country in the world? What determined the degree to which countries were affected? Why did some currencies experience large swings in value while others did not? And why did some countries experience large reserve losses?

These are all important questions, and, as of now, these are questions for which we have no definite answers. To some extent, this paucity of answers is not surprising since we still debate a similar set of questions regarding the international transmission of the Great Depression (e.g., whether staying on the Gold Standard longer, or devaluing less, made the depression worse for countries that pursued this policy). Puzzles regarding the Great Recession we are living through now will likely remain for a long time.

However, the paper suggests some interesting answers to these questions: (1) financially more globalized economies experiences a more severe external pressure; (2) countries with more foreign liabilities relative to their financing needs also experienced a more severe pressure; (3) countries with more foreign liabilities concluded or were forced to counter this pressure by depreciating their currency more rather than by spending foreign reserves; (4) the large built-up of reserves that was one of the more novel phenomena of the decade preceding this crisis went largely under-utilized as a buffer to protect against the sudden onslaught of the crisis.

Professors Aizenman and Hutchison reach their conclusions by examining a currency pressure index they construct using data on nominal exchange rate movements and changes in foreign exchange reserves. Once they construct this index, they proceed to examine its determinants in a set of emerging market countries.

Hopefully, the authors view this as preliminary work in a bigger project since the questions they pose are important and require a thorough investigation from many angles. Two additional issues seem salient in discussing this work:

1. The index

The paper uses an exchange pressure index that is very similar to the index that is commonly used in the currency crisis literature (e.g. Frankel and Rose, 1996 or Glick and Hutchison, 2005). It is constructed from the sum of the change in the nominal exchange rate and the change in foreign reserves, typically weighted by the past volatility of these series. However, the authors choose to sum these measures without weighing. This is intentional and, I think, warranted, given the authors aim of finding the structural differences that led different economies to be exposed differentially to the crisis.

Other papers that have also recently examined the determinants of the different exposure of countries to the crisis used other alternative 'exposure' indices. In particular, they measured the severity of the crisis in various countries using national stock market declines, sovereign credit downgrades or measures of post-crisis economic activity like GDP growth declines or the changes in per capita GDP levels (e.g. Rose and Spiegel, 2010, and Lane and Milesi-Ferretti, 2010).

There is no simple answer to the question 'which measure is better?' However, given the aim of this particular work—to examine the international transmission of the crisis through the global financial markets—the authors' choice seems the right one. Future work may consider more thoroughly why indeed the emerging markets chose not to spend much of their accumulated reserves in spite of the large depreciations that followed that choice. To answer that question, a better identification of the time frame in which these decisions were undertaken, using higher frequency data, may be required.

Most of the emerging markets that are included in the sample do not appear to have been linked to the U.S. real-estate bubble and/or banking crisis directly, but rather through the sudden-stop in funds that arose once credit suddenly disappeared after the fall of Lehman Brothers in September, 2008. Given this likely channel of transmition, it would be interesting to examine whether the extent of the crisis is related to a sudden stop in capital inflows that has been pointed out as a culprit in the Asian crisis of 1997-1998 (e.g., Calvo and Reinhart, 2000, and Hutchison and Noy, 2006).

2. The sample based on the MSCI

The authors construct their market pressure index for 90+ countries, but then proceed to estimate the determinants of this index for a subset of emerging market countries. This subset is based on the Morgan Stanley Capital International (MSCI) Emerging Market Index. It seems that the criteria determining inclusion in this list are puzzling, at best. Countries that are clearly 'emerging', in the sense of rapidly gaining a foothold in the global economy, are not included (e.g., Vietnam, Bangladesh, Costa Rica, or Slovakia) while countries that are probably globalizing much less rapidly, if at all, are (a prominent example is Pakistan). Clearly, non-emerging economies, ones in which financial markets are not becoming more integrated with the global market, would be effected differently and should therefore be excluded from this sample. However, the criteria that MSCI uses is both non-transparent, and confusing.

An alternative external source to determine which countries should be included in this kind of project seems to be warranted. Using the World Bank's designation of an upper-middle inclime country looks especially appealing given its transparency.

References

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