

Crises: The Price of Globalization?

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Global Economic Integration: Opportunities and Challenges

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Globalization was once believed to reduce the likelihood of widespread financial crises. Spectacular crises, however, have persisted despite widespread integration of economies, leaving observers to wonder whether crises will coexist with international integration. The author reviews the latest models of financial crises to understand how crises begin and how to contain them. He concludes not only that postcrisis policies are largely ineffective but also that crises will recur.

Decades ago, the inexorable trend toward increased globalization—the integration of economies through reduced financial restrictions, which encourages trade—was heralded as a panacea to curb financial crises and their aftershocks. The story went as follows: As developing countries opened their economies to trade, Western lenders' confidence in these countries grew; a large share of exports to overall economic activity (i.e., GDP) was evidence that an emerging country was serious about avoiding damage to its fledgling economy by defaulting.

Despite the proliferation of global trade in recent years, developing economies that have opened to trade have been the catalysts of far-reaching, breathtaking crises—most notably the Latin America debt crisis of the 1980s and, more recently, the 1997 Asian currency crisis and its ongoing contagion. Observers now wonder whether globalization promotes crises rather than assuaging them.

Krugman reviews the financial literature on modern crises to understand their causes better, especially the interrelationship between international trade and the aggregate balance sheets of private companies, now the main borrowers in developing countries rather than the governments of developing countries, which dominated during the

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1980s. Krugman categorizes models into two camps: (1) those that view crises as the result of a borrowing and investment frenzy gone bust and (2) those that view crises as a temporary jump to an unstable equilibrium during a panic. Krugman reports that the second category has edged out the first category in models developed since 1997.

The genesis of panic-driven crisis models is Diamond and Dybvig's work (*Journal of Political Economy*, 1982), which was originally used to model bank runs, an ever-present threat stemming from the intentional duration mismatch between a bank's assets (long-term loans) and liabilities (short-term deposits). Chang and Velasco (NBER working paper, 1999) apply the bank-run model to international financial crises, but Krugman contends that more-accurate models must also account for an economy-wide currency mismatch. Aghion et al. (mimeo, 1999) partially develop a model analogous to Mundell–Fleming, the classic open-economy paradigm in which equilibrium is the intersection of international trade and asset markets, defined in terms of the exchange rate and GDP.

Krugman uses the Aghion et al. model to assess the ability of postcrisis macroeconomic policies to fight a massive currency depreciation, which initially fuels a crisis. (Note that the Aghion et al. model shows ambiguous effects on economic activity caused by currency depreciation.) Justifying the model outcomes with empirical and anecdotal evidence, Krugman reports that many policy choices may be costly or ineffective.

Krugman reviews methods that developing countries may adopt to prevent crises: floating exchange rates; domestic adoption of a credible foreign currency, such as the U.S. dollar or the euro (dollarization); and restrictions on either capital inflows or outflows. Krugman points out, however, that some of these preemptive measures might discourage rather than enhance globalization, which Krugman wishes to nurture.

Krugman contends that globalization has been generally successful in promoting economic activity in emerging economies and that vulnerability to crises is the price to pay for that growth. The continuing upward trend in economic integration, especially in the populous economies of China and India, means that the threat of widespread financial crisis will loom.

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