Financial Contagion and Vulnerability of Asian Financial Markets

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A Discussion

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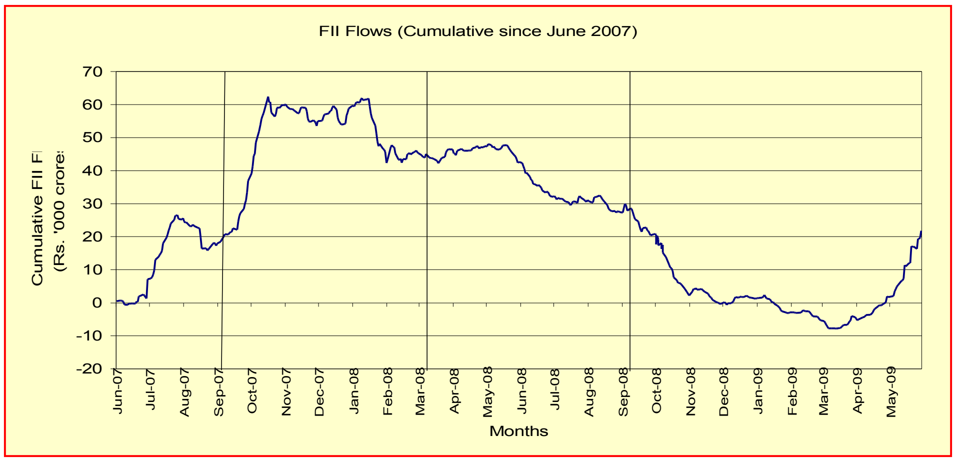
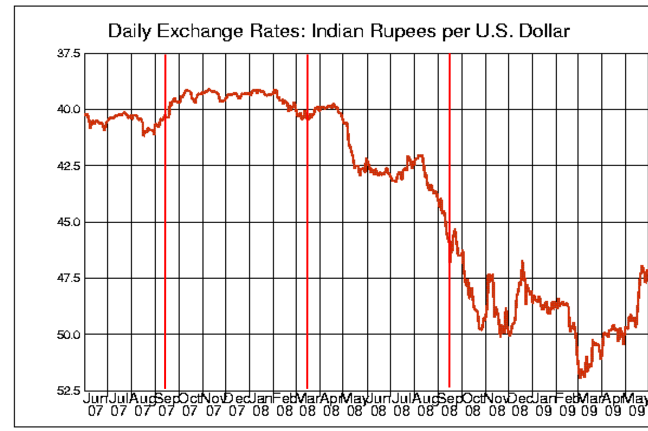
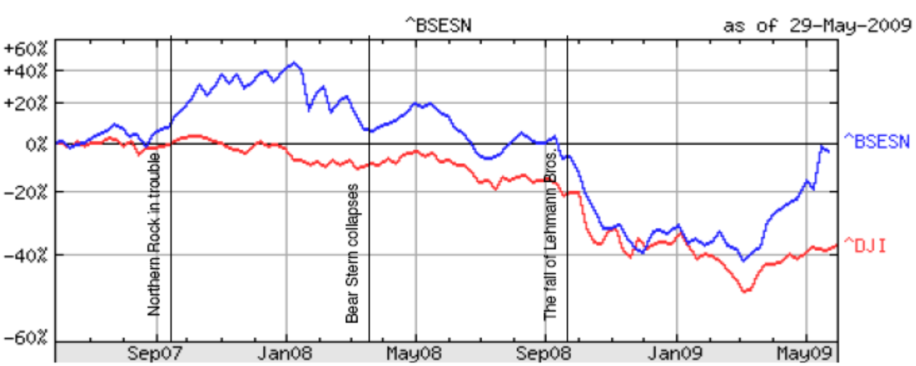
"Big picture" and motivation

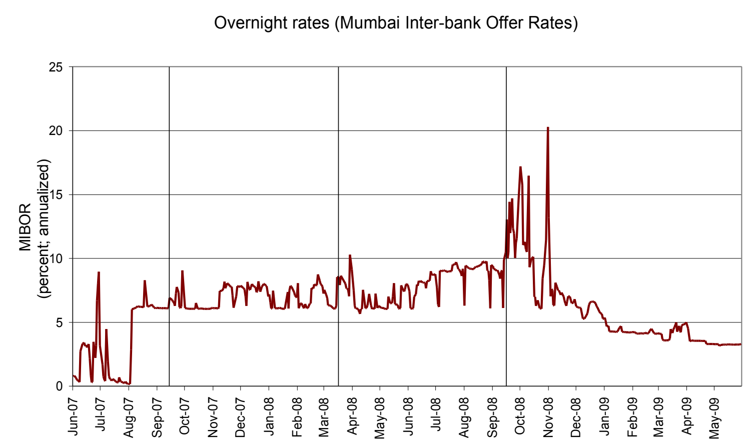
- Financial integration – benefits and costs
  - Diversification vs. contagion
  - Asian countries affected by a crisis not of their making
    - Without direct exposure to toxic assets
    - "Common lender" or "common investor" effects
    - a result of leverage constraints
  - Financial ties stronger than trade ties
- A model to explain the transmission mechanism

Just look at India to agree… Transmission

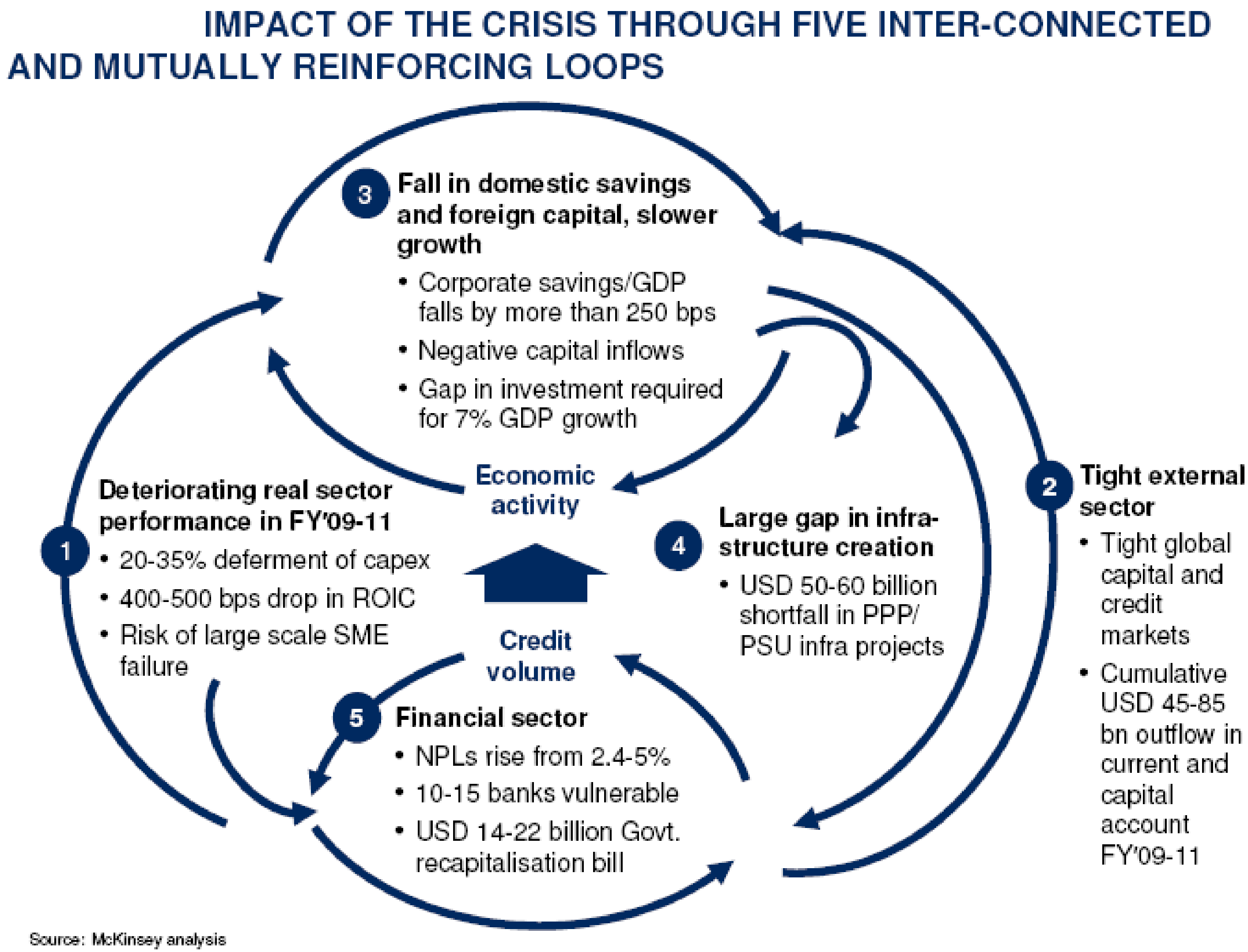








Just look at India to agree… Real effects



Crises change the rules of the game

Figure 3. Regional Average Covariance

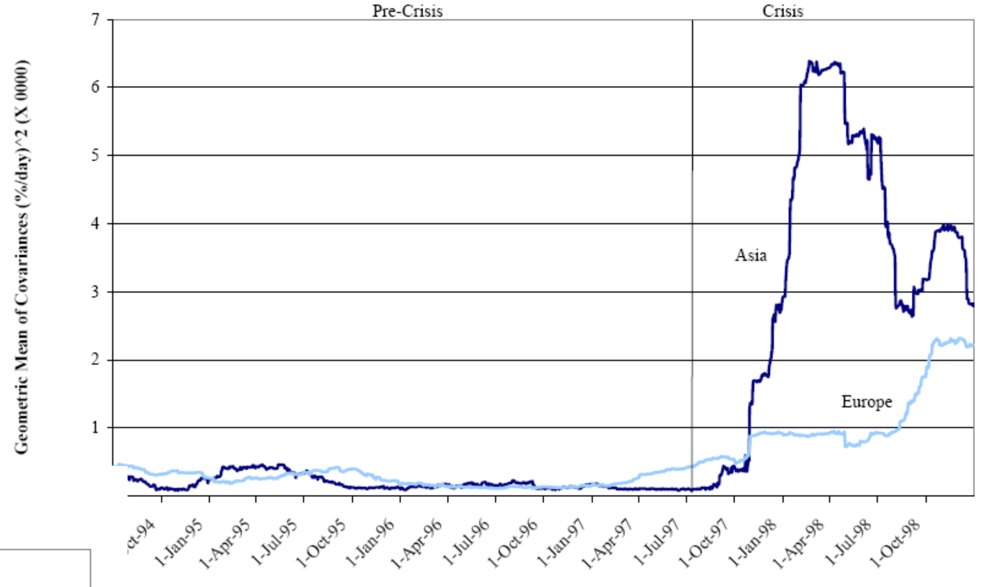


Figure 4. Regional Average Correlation

Existing literature

The spread of a crisis depends on the degree of financial market integration. If a country is closely integrated into global financial markets, or if the financial markets in a region are tightly integrated, asset prices and other economic variables will move in tandem. The higher the degree of integration, the more extensive could be the contagious effects of a common shock or a real shock to another country. Conversely, countries that are not financially integrated, because of capital controls or lack of access to international financing, are by definition immune to contagion. In this sense, financial markets facilitate the transmission of real or common shocks but do not cause them. The actions of investors that are ex ante individually rational as well as collectively rational, even though they lead to volatility and may require policy changes, should be grouped under fundamental causes.

Contagion: Understanding How It Spreads

Rudiger Dornbusch • Yung Chul Park • Stijn Claessens

The World Bank Research Observer, vol. 15, no. 2 (August 2000), pp. 177–97.

Existing Literature

However, capital account liberalization is not an appropriate policy objective for all countries and in all circumstances. For poor countries with weak policies and institutions, capital account liberalization should not be a major priority. However, even this group includes some poor but resource-rich countries that are having to deal with capital inflows and their mixed benefits. These countries need a strategy, rather than just coping in an ad hoc way with the whims of international investors. Indeed, a key lesson from country experiences is that capital account liberalization works best when other policies are disciplined and not working at cross-purposes (Arteta, Eichengreen, and Wyplosz, 2003).

A Pragmatic Approach to Capital Account Liberalization

Eswar S. Prasad and Raghuram G. Rajan

Journal of Economic Perspectives—Volume 22, Number 3—Summer 2008—Pages 149–172

Concluding remarks

- Good paper on an important topic
- Suggestion: Authors may work a bit more on differentiating from the existing literature

Thank you