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Globalization and the 'confidence game'

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Abstract

We show that governments in developing countries have an incentive to play the "*confidence game*" — wherein the need to win the confidence of the international capital market 'can actually prevent a country from following otherwise sensible policies and force it to follow policies that it would normally consider perverse'. This incentive arises because of a combination of a 'conformity bias' and 'good news bias' in governmental decision making in an open economy, which results in inefficient outcomes which increases rather than decreases the threat of devaluation. While institutions that encourage greater transparency and the public revelation of information, may often mitigate this inefficiency, on some occasions increased transparency may even exacerbate the inefficiency.

Keywords: Globalization; Devaluation; International capital markets; Currency crisis; Transparency

JEL classification: F33; F40

1. Introduction

The globalization of capital flows in recent years, has increased access to international capital markets for many developing countries. This globalization is believed to have the potential to discipline governments in developing countries. This is because it is perceived that in order to *attract* foreign capital, governments have to pursue 'sound' economic policies in order to boost 'market confidence' (Camdessus, 1998).[1] While this view seems quite plausible, the recent spate

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[1] This view has been echoed by Obstfeld (1998), Feldstein (2000) and Summers (2000). For another instance consider Dornbusch (2000) who says that on facing a crisis, a finance minister will "have the ambulance rush them to the IMF. And when they do, *markets start taking confidence very soon and from there it is a short step to normalization*" (emphasis added). An excellent discussion of the issues involved in Krugman (1999) and Rodrik (1999).

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of currency crises seems to suggest that the 'disciplining' role of the international capital market has at the very least, not been very effective.

In a perceptive commentary Krugman (1998, 1999) suggests a potential reason. He argues that inefficiencies might arise because policymakers in the global economy feel compelled to play the 'confidence game' — where the preoccupation of policymakers is not with economic fundamentals but with winning market confidence. There is a temptation to implement "*… policies that may not make sense in and of themselves but that policymakers believe will appeal to the prejudices of investors…In fact the need to win that confidence can actually prevent a country from following otherwise sensible policies and force it to follow policies that would normally seem perverse*."[2] This opinion has been echoed by Bhagwati (1998), Rodrik (1998) and Stiglitz (2002) who also conjecture that globalization and the free flow of capital has resulted in developing countries feeling 'compelled' to enact policies that may be inappropriate. This is somewhat easier to understand if there is a fundamental dissonance between the developmental goals of a country and the interests of foreign investors.[3] It is more puzzling once we recognize that both — a productive economic environment and increased foreign capital, raise national income. However, in this paper we argue that once we take account of the *signaling* aspect of policy choice, the desire to attract foreign capital rather than 'discipline' governments, generates perverse incentives for policymakers and results in inefficient outcomes — making currency crises more rather than less likely.[4] In that sense this paper provides an analytical underpinning to the opinions voiced by Krugman, Bhagwati and Rodrik in recent years, that globalization and the free flow of capital might generate perverse incentives for governments in developing countries.

In our framework, a government that is interested in defending a fixed exchange rate, chooses between policies. Two features of our framework are worth highlighting. First, policies are assumed to be state-dependent. We assume that different policies are 'appropriate' for different states of the world — no policy is intrinsically superior to the other. Therefore, if the government has a very strong foreign reserve situation, the 'appropriate' policies are likely to be very different from the policies that it should pursue when its foreign reserve situation is precarious. Given this state-dependence, policymaking for the government would seem to be a simple matter of matching the 'appropriate' policy to the corresponding underlying state. However, what complicates matters is that the government does not know for sure, the underlying state of the world. This brings us to the second important aspect of our framework. In particular, the government has reliable (even if not perfect) private information about the underlying state of the world. In this framework, we show that with the globalization of capital flows, governmental decision making in developing countries might suffer from inefficiencies. In particular, we argue that, the very attempt to maintain 'market confidence', may result in governments feeling 'compelled' to enact (or persist with) policies that have an adverse impact on the economic environment.

We identify two situations under which this might happen and governments have an incentive to play the 'confidence game'. The first reason why governments play the 'confidence game'

[2] This quote is from Krugman (1998).

[3] Rodrik (1998) argues that the free flow of capital can make policy making in "..'emerging market' countries hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt and New York. A finance minister whose top priority is to keep foreign investors happy will be one who pays less attention to developmental goals".

[4] Our analysis also helps throw light on the alleged 'failure' of economic policies in stemming the South East Asian crisis. See Radelet and Sachs (1998) and Wade and Veneroso (1998) for an elaboration.