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Is contagion a myth?

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These days people talk freely about “financial contagion”. Too freely. It is worth asking whether there is any such thing

THE economic crisis that started in Thailand and then spread, first across much of Asia, and then to Russia and Latin America, seems a perfect example of financial contagion. Economies that looked healthy one moment were seriously ill the next—not, apparently, because of any new development within their borders, but because of a shock from abroad, in the form of a withdrawal of international investment.

The fear that otherwise-healthy economies could fall victim in this way is one of the scariest aspects of the world’s current troubles—and one of the most portentous. It challenges the idea that a country should open its borders to goods and capital: perhaps, after all, the benefits do not outweigh the risk of infection.

This seemingly uncontroversial notion of contagion also influences the debate over how far, and in what way, the sick among the emerging-market countries should be helped towards recovery. If contagion is real, helping the victims also helps other countries, which might have caught the disease in future, to stay healthy. Measures to curb the infection become an international public good, serving a much broader interest than that of merely bailing out the borrowers and lenders most directly concerned.

The idea of contagion had better be right, then: a lot is riding on it. But some economists insist it is wrong. At a conference organised by the Cato Institute (and sponsored by *The Economist*) last week in Washington, DC, Michael Bordo, an economic historian at Rutgers University, said he knew of not a single case of financial contagion—not just recently but ever. In every financial crisis he had studied, going back over centuries, when investors had withdrawn their capital they had had good domestic-economy reasons for doing so. Capital had never flown suddenly, so far as he knew, from economies where all was well save for the spillover effects of some other country’s troubles.

Crises do tend to arrive in clusters, advocates of this view would admit. This points not to contagion, however, but to a “demonstration effect”. Investors may not realise that an economy is struggling. When some similar or neighbouring economy gets into trouble, they turn back and look more closely. If they see difficulties, albeit not yet acute, similar to the ones that brought the wrath of creditors down on the first victim, they will withdraw their money from others as yet unaffected. This may drag more economies down. But it is not contagion: the new victims are not innocent bystanders.

Victim heal thyself

Put this way, the case against contagion seems plausible. Nobody disputes that the crisis in Thailand centred on bad policies—notably, its bungled partial deregulation of the financial sector (including the notorious Bangkok International Banking Facility, which encouraged hard-currency lending to weak borrowers), its large and persistent external deficit, and its overvalued exchange rate. The Asian countries to which the crisis then spread had similar, if milder, weaknesses. Next, Russia: a disaster waiting to happen. Policies were better in most of Latin America, but far from all right, as Brazil’s new austerity programme tacitly admits.

Very well, the idea that international capital wanders the globe like a horrible disease, inflicting random havoc on brave little economies, can certainly be ditched—if that is what “contagion” means (not that anybody who believes this caricature gives a damn about accurate terminology or basic common sense). But “contagion” also

seems the right word to apply to a different situation—one in which (a) information and/or perceptions about the creditworthiness of a borrower change (the demonstration effect) *and* (b) lenders' willingness to lend, under any given set of borrower-country policies, changes too.

Suppose many countries are badly governed, but some are governed worse than others—which seems plausible. The really bad cases may succumb to financial crisis whatever happens anywhere else; in such cases the demonstration effect is fatal by itself, and public-good anti-contagion policies are futile. But the fate of countries with mildly bad policies is not open and shut; it is delicately balanced.

Given full information (that is, assuming that the demonstration effect has already kicked in), lenders may be willing to continue financing countries with mildly bad policies provided that business elsewhere is good. Equally, they may be unwilling to finance those very same countries if business elsewhere is bad. In a good state of the world, with full information, mildly bad policies go unpunished; in a bad state of the world, again with full information, mildly bad policies get hammered.

For countries that are vulnerable in this way to external shocks, yet not doomed to go under whatever happens, international policies to stave off "contagion" still make sense. An initial emergency, such as Thailand in 1997, will create a demonstration effect that drives other badly governed countries to the wall. This first stage, let us suppose, is not contagion; these other bad cases would have been found out sooner or later anyway. But as the trouble spreads and deepens, countries that are merely vulnerable—countries that might have avoided a crisis altogether if only international conditions had not deteriorated this much—get drawn in. And so the distress cascades downwards from group to group, perhaps never reaching the well-governed (wherever they may be), yet still going further than it need have done.

Obviously this argument does not establish the case for public-good remedies. Other questions, many of them centred around moral hazard, still need to be answered. What it does suggest is that a kind of "contagion" must after all be contended with, and that the search for international remedies is worth pursuing.