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## Comment Rudiger Dornbusch

Calvo and Mendoza's paper is an enviable piece of research in being both topical and thoroughly elegant. The theory is state of the art, the execution is flawless. Here is a theory of speculative attacks caused by masses of investors who find it far more profitable to run away than to ascertain whether the rumors are true: "Don't ask questions, run" is the bottom line and this follows rigorously from the model. It is an uncomfortable conclusion but not altogether an implausible one, since the world does appear to warmly welcome emerging market assets one day and then, on sheer rumor, desert those assets at the drop of a hat.

Fortunately for world capital markets, Calvo and Mendoza's conclusions are far less threatening than they might appear at first sight. While the conclusions do follow rigorously from their assumptions, the authors omit a key aspect of this world—financial intermediaries. Calvo and Mendoza envisage a continuum of "unit-size" investors who face fixed costs of

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ascertaining the facts; this is the way to make information really costly, and all the rest follows. Of course, their model is a parade piece in explaining how in the real world we would quickly see the emergence of financial intermediaries.

Financial intermediaries would pool resources from all the unit-size investors and, using scale to reduce the costs of information gathering, they avoid or sharply reduce the prevalence of Calvo-Mendoza runs. True, in their world people should run rather than assume the risk of throwing good money after bad to find out whether the bad news is *really* bad. But once we include financial institutions that specialize in establishing information in a cost-effective way, all this simply goes away.

There is a second flaw in the paper. In an attempt to catch the theme of the day, "contagion," the paper tries to categorize the simultaneous flight of all unit-size investors on learning the rumor as contagion. There is no contagion here: Just because everybody does the same thing—correlation—does not mean that some Lotka-style infection is spreading. The authors state, "When a rumor suddenly favors another 'market portfolio' . . . contagion prevails and 'all investors follow the herd.'" But this is not necessarily so; the investors may simply all be doing the same thing—no leader, no follower, nobody egging others on or infecting.

A third concern regards the finding that globalization is bad. This is a surprising result in a microeconomic perspective. Why would market segmentation dominate, in rigorous welfare assessment, an open world capital market? Anyone finding such a result ought to be suspicious unless market failure is patent and remedy is left out of consideration. Globalization in the Calvo-Mendoza model means that investors have available low-risk, diversified portfolios not including any one particular country—that is why a policy of running without further questions is not costly—as they note "the full adverse effect of globalization on information gains is transmitted with about a dozen countries."

Somewhere along the line the benefits of diversification disappear and the focus is put sharply on the country that can be dropped from the portfolio without much loss. In this paper, one reason not to desert a rumor-struck country is poor diversification once it is dropped from the portfolio. But if there are many countries in the world, any single country becomes dispensable. This is the key ingredient for the Calvo-Mendoza conclusion that globalization is a problem. Having already concluded that financial intermediaries are there to develop the useful information on any one country, we can safely dismiss the globalization alarm that comes from this paper. Diversified portfolios are wonderful for investors and financial intermediaries are wonderful in developing useful information essential to sound investment; when the two meet we have the best of all worlds. This paper does nothing to dismiss the case and, unfortunately, does nothing to add to our understanding of financial crises on the periphery.