

Readings in International Economics

Autumn 2011 – Winter 2012

Lecture 5: The freedom of capital flows and
financial crises in emerging economies

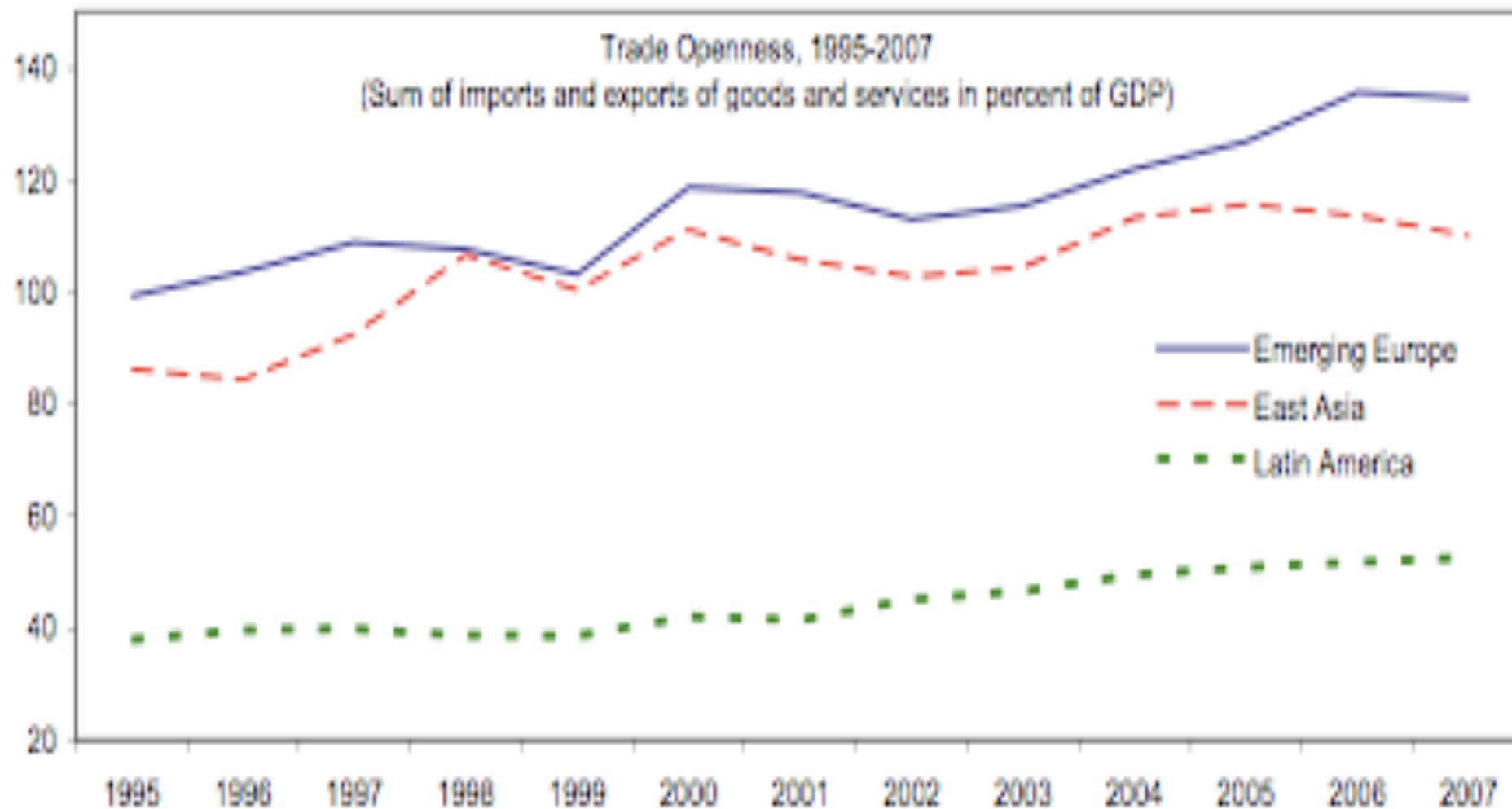
29 November 2011

Summary of the previous class

- Liberal and protectionist trading regimes
自由貿易、保護貿易
- Protectionism: using various policy instruments to restrict imports and promote exports
輸入制限、輸出促進
- Three periods of free trade since 1870s
- **Developing countries maintained protectionist regimes from the end of WWII until the 1980s, but have been open to international trade since the early 1990s (trade globalization)**
- **Increasing trade openness**

Trade openness by region

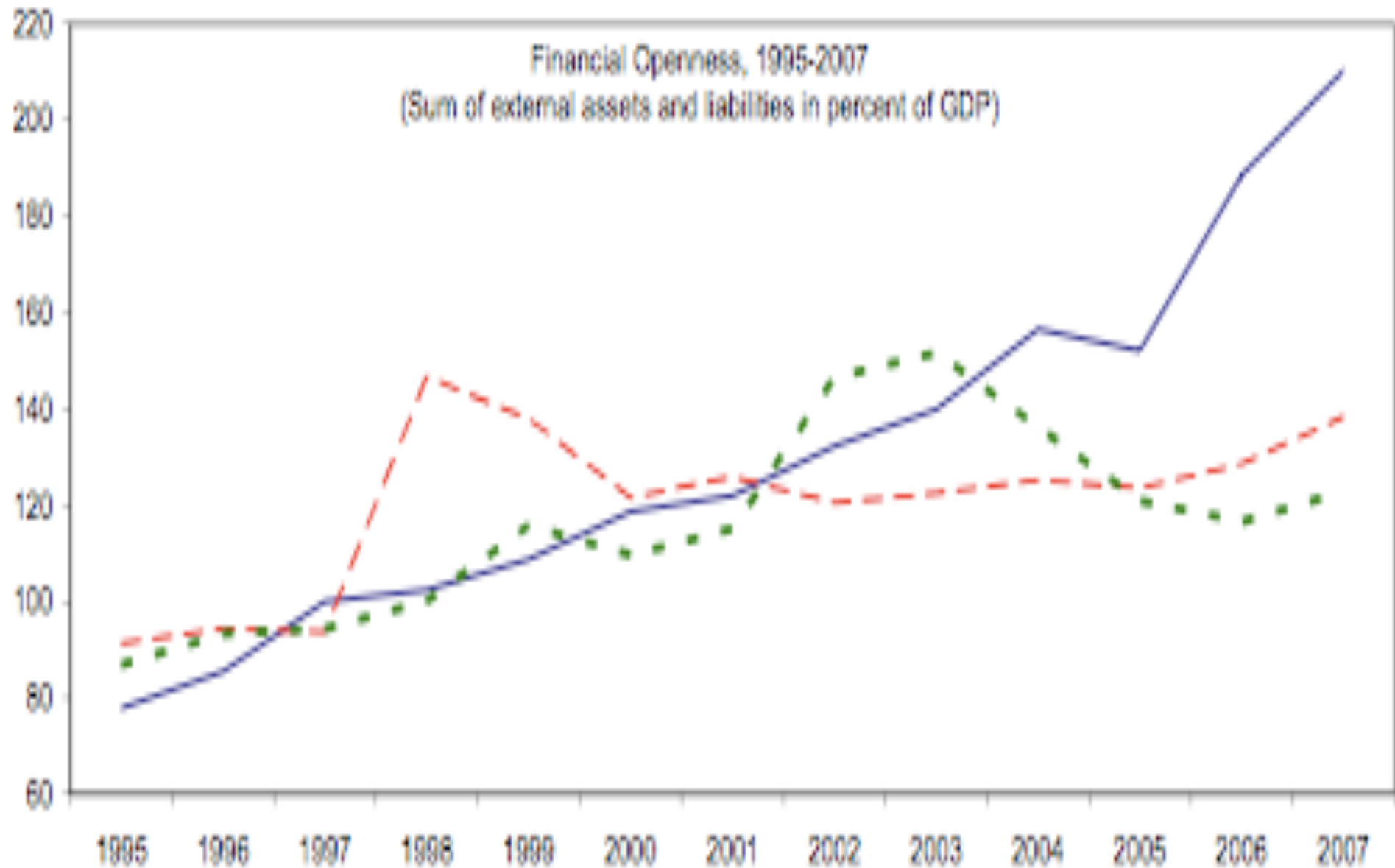
Figure 7. Regional Trends in Trade and Financial Openness, 1995-2007



Financial globalization

- Before the early 1990s
 - ★ capital could not flow freely during the Bretton Woods era (1945-1973) because of **capital controls** (i.e. taxes or other restrictions on international transactions in assets)
資本移動規制
- Types of foreign capital: FDI, foreign portfolio investment (e.g. investment in shares and bonds), foreign bank loans, foreign aid
外国直接投資、外国証券投資、外国銀行融資、対外援助
- Since the early 1990s, **capital account liberalization** → free flow of all types of foreign capital across countries
- 資本自由化
- **Increasing financial openness**

Financial openness by region



Trade vs. financial globalization

- A generally positive attitude towards trade openness
- But freedom of capital flows has been the subject of a huge controversy

資本自由化の是非についての論争

- **Main reason: the link between capital account liberalization (leading to large capital inflows/outflows) and financial crises in developing countries**
- Example: large capital inflows in the early 1990s followed by sudden capital outflows → the East Asian financial crisis of 1997 and the reintroduction of capital controls by Malaysia in 1998-1999

Financial crises in emerging economies

(According to Reinhart and Rogoff, 2009)

- 1. High inflation (20% or higher per year) or hyperinflation (40% or higher per month)
高インフレ、ハイパーインフレーション
- 2. Large currency depreciations (25% or more per year) or “currency reforms”
大幅な通貨切下げ・下落
- 3. Bank runs and bank failures due to the increase of “bad loans”
取り付け騒ぎ、不良債権増による銀行の破綻
- 4. Defaults on external or domestic government debt
対外・国内債務不履行(デフォルト)

“Twin crises”

- *Currency and banking crises can occur at the same time and reinforce each other*

通貨危機と銀行危機が同時に起き、互いに補強しあう

- (1) Currency depreciation → the burden of repaying foreign currency denominated loans (by banks, companies and households) grows → bankruptcies and defaults → the proportion of “bad loans” increases → banking crisis
- (2) Bank runs and failures → the confidence of foreign investors diminishes → sudden and massive outflow of foreign capital (due to “herd behavior”) → sharp currency depreciation

The debt crisis of the 1980s

- Started from Mexico in 1982 and spread to other Latin American countries (“the lost decade”)

「失われた10年」

- The crisis background I: high oil prices in the 1970s → huge “petrodollar” earnings of the OPEC member countries

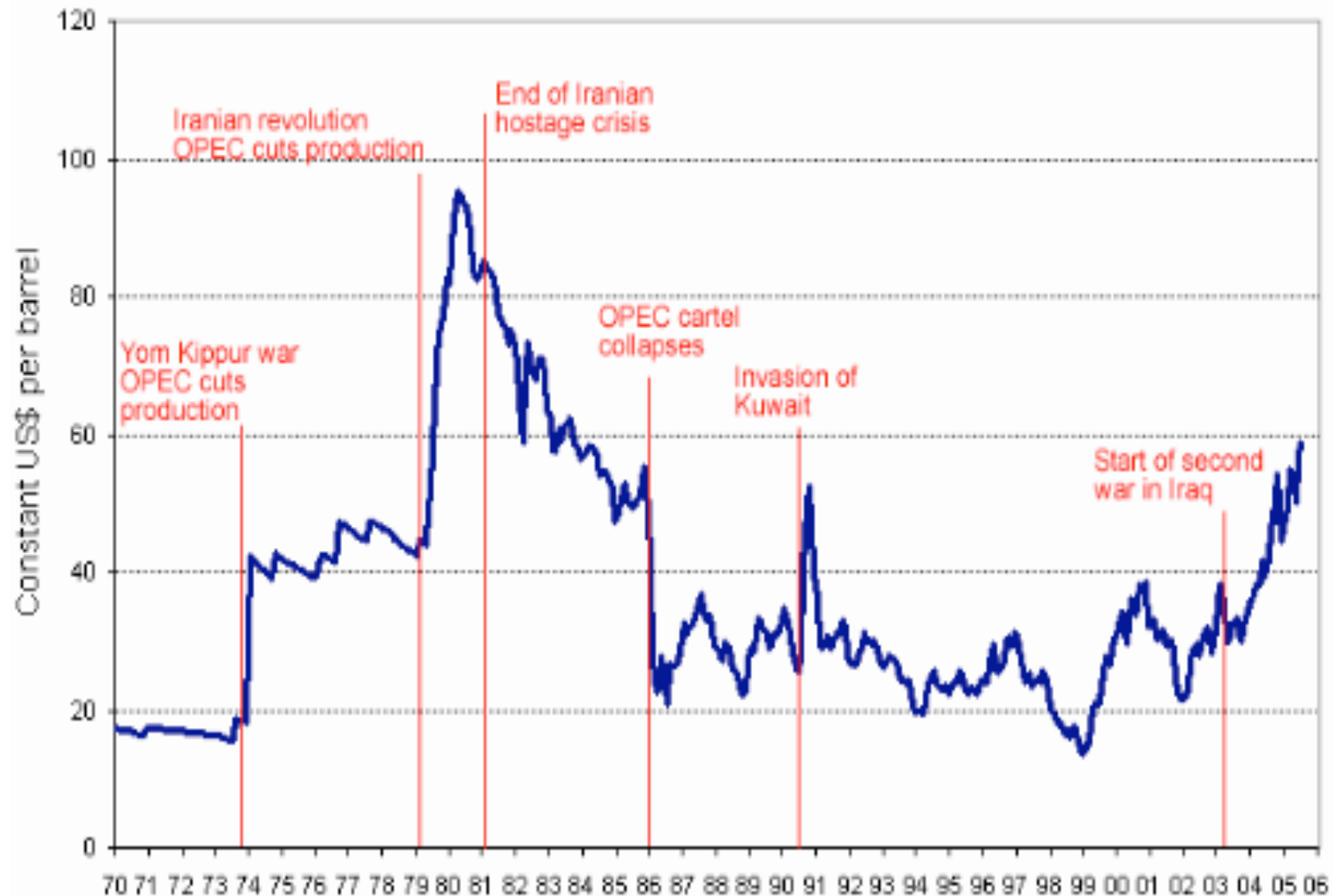
原油高 → オイル・マネー

- The crisis background II: low interest rates in the US and other advanced countries in the 1970s

アメリカ等の先進国における低金利政策

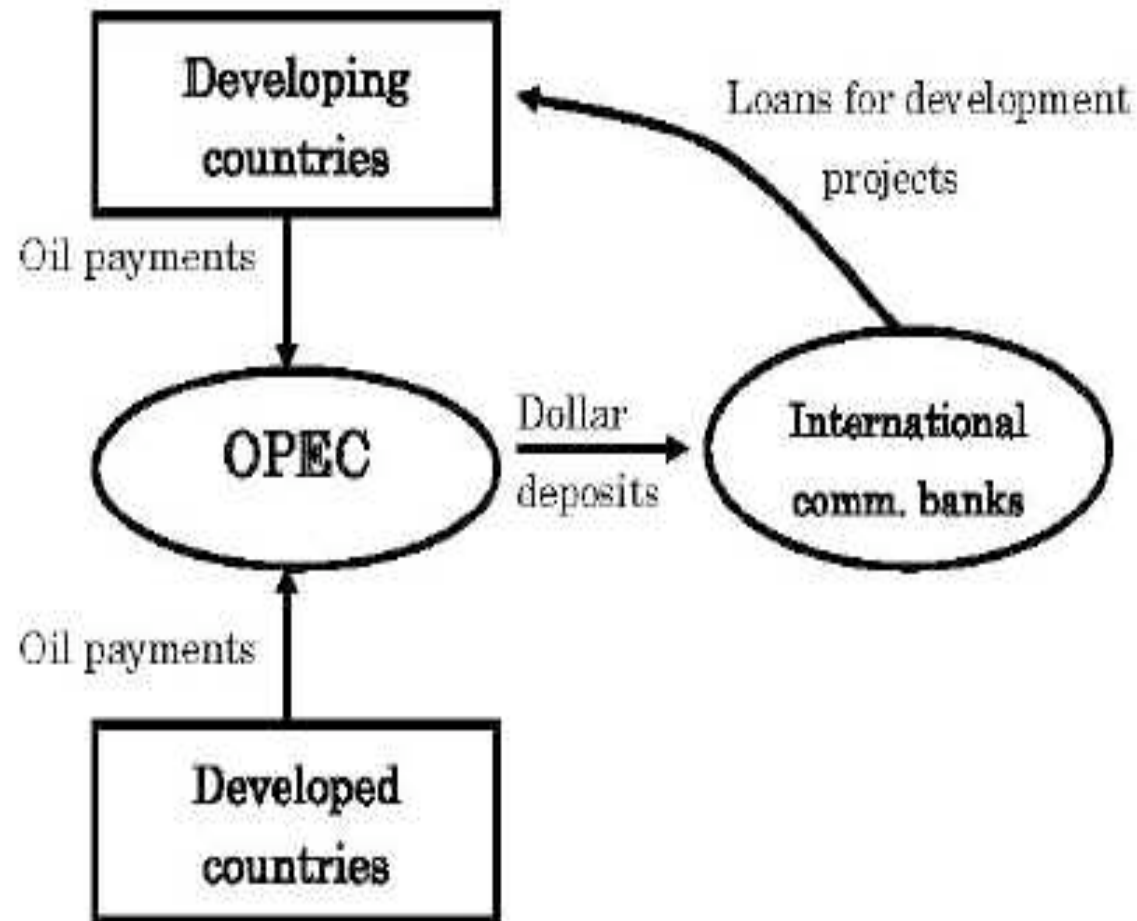
- The “petrodollars” flowed into Western banks, which lent them on to developing countries pursuing aggressive industrialization strategies (Brazil, Mexico, South Korea, etc.)

High oil prices in the 1970s (WTI in constant US\$ per barrel)



The movement of “petrodollars”

1970s: Oil Dollar Recycling



Causes of the 1980s crisis

- In 1980, the Fed (the US central bank) raised interest rates, leading to an economic slowdown

アメリカの金利引き上げ

- The channels through which higher US interest rates influenced the developing countries who had borrowed the “petrodollars”:

(1) External debt service payments increased

対外債務支払い金額の増加

(2) Export earnings fell due to the economic slowdown in advanced countries and the decline in commodity prices

輸出収入の激減

Consequences of the 1980s crisis

(1) External debt defaults in developing countries

對外債務不履行

(2) Strong powers of the IMF over developing countries (“IMF conditionality”)

The 1990s crises I

I. Mexico in 1994

- The peso was fixed to the US dollar in 1988 and (in spite of small devaluations) became largely overvalued in real terms
- CA deficits of more than 7%, covered by foreign capital inflows
- But a large part of the foreign capital was investment in “*tesobonos*” (short-term government bonds)
- Political instability due to election-related violence → foreign investors fled → floating and large depreciation of the peso
- Contagion to other Latin American countries (the so-called “*tequila effect*”) 同地域の他国への伝染

**Figure 2: Mexico's Foreign Exchange Reserves,
July 1993 – Dec. 1994**

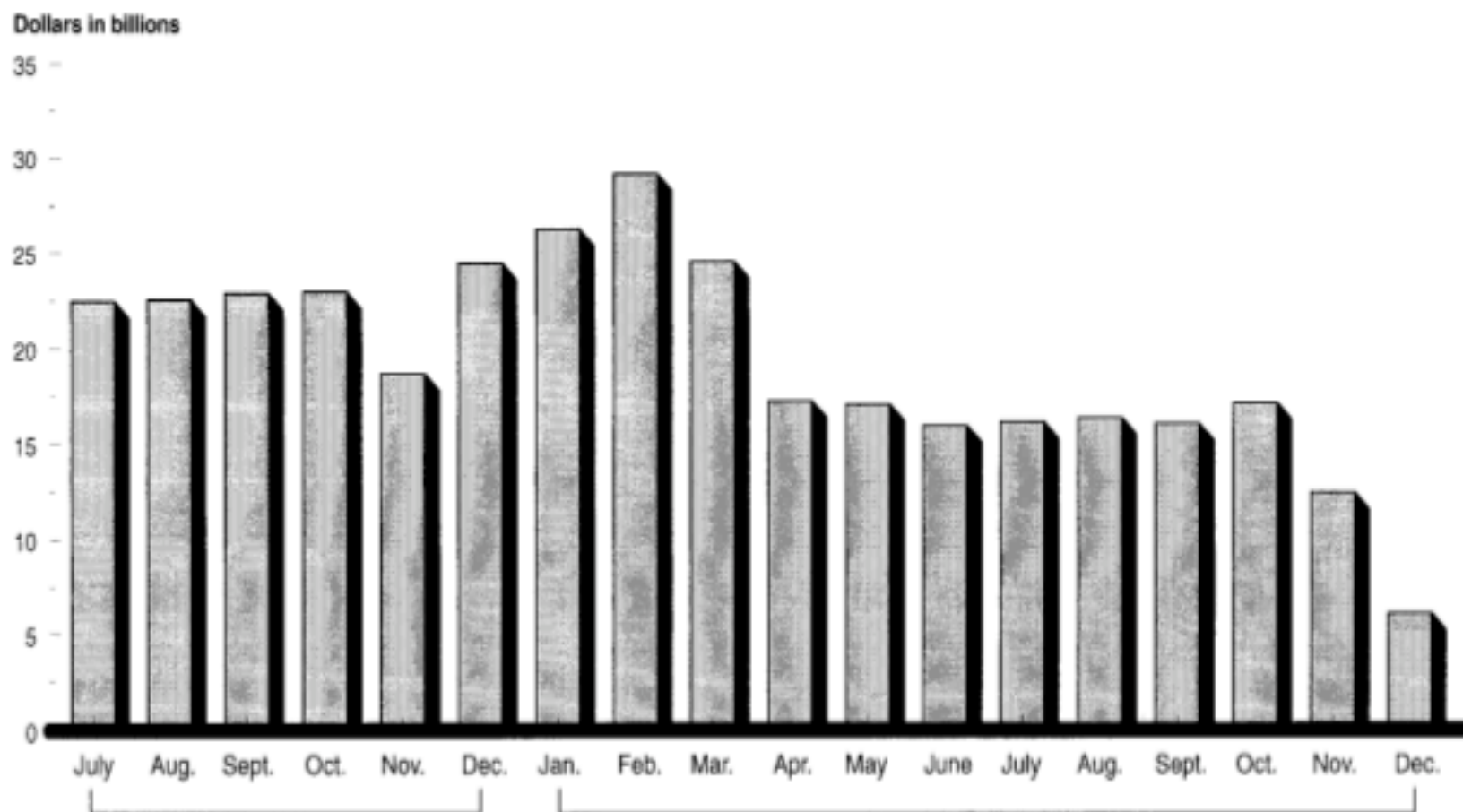


Figure 3: Mexico's Current Account Deficit, 1988-94

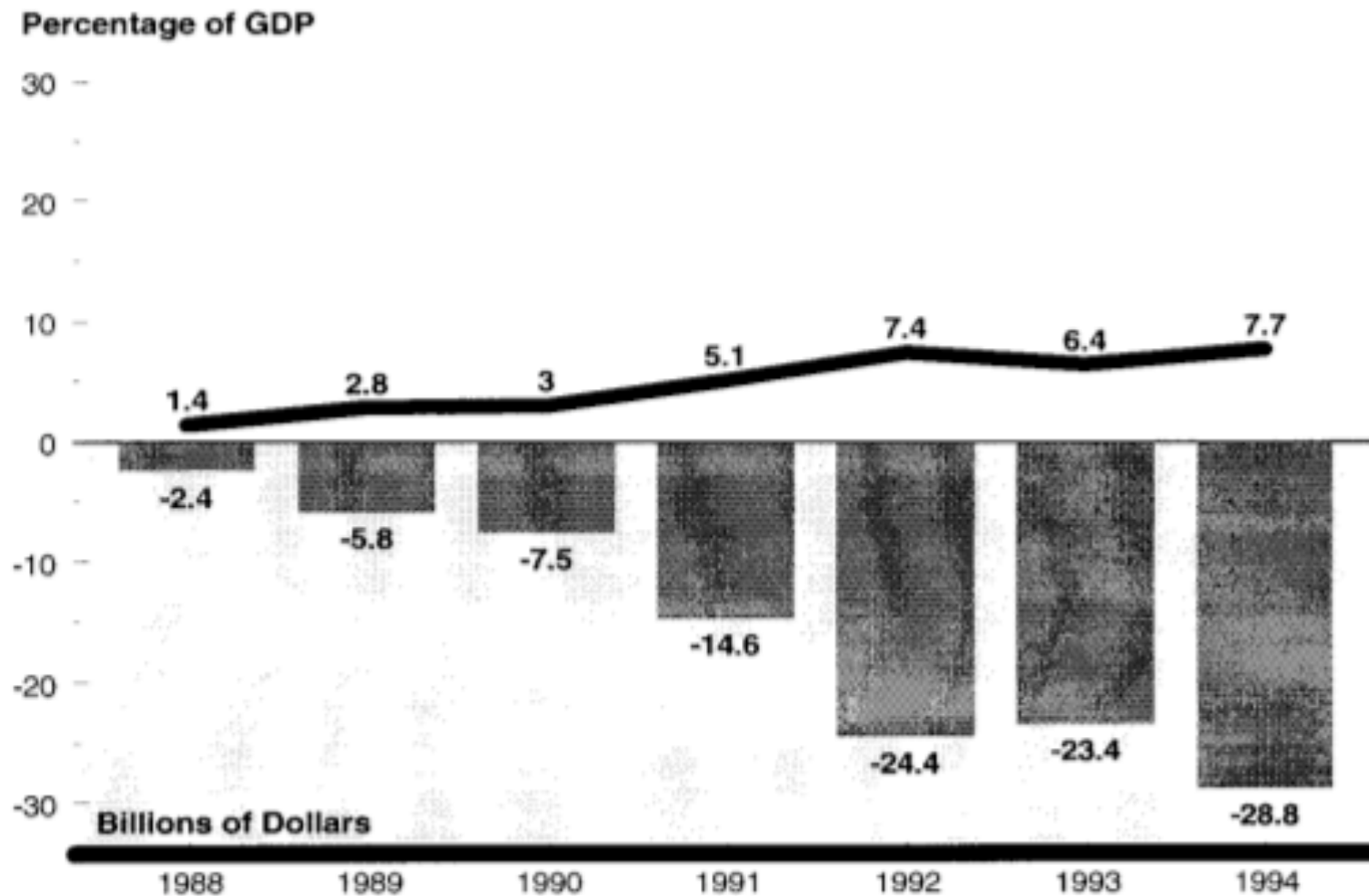
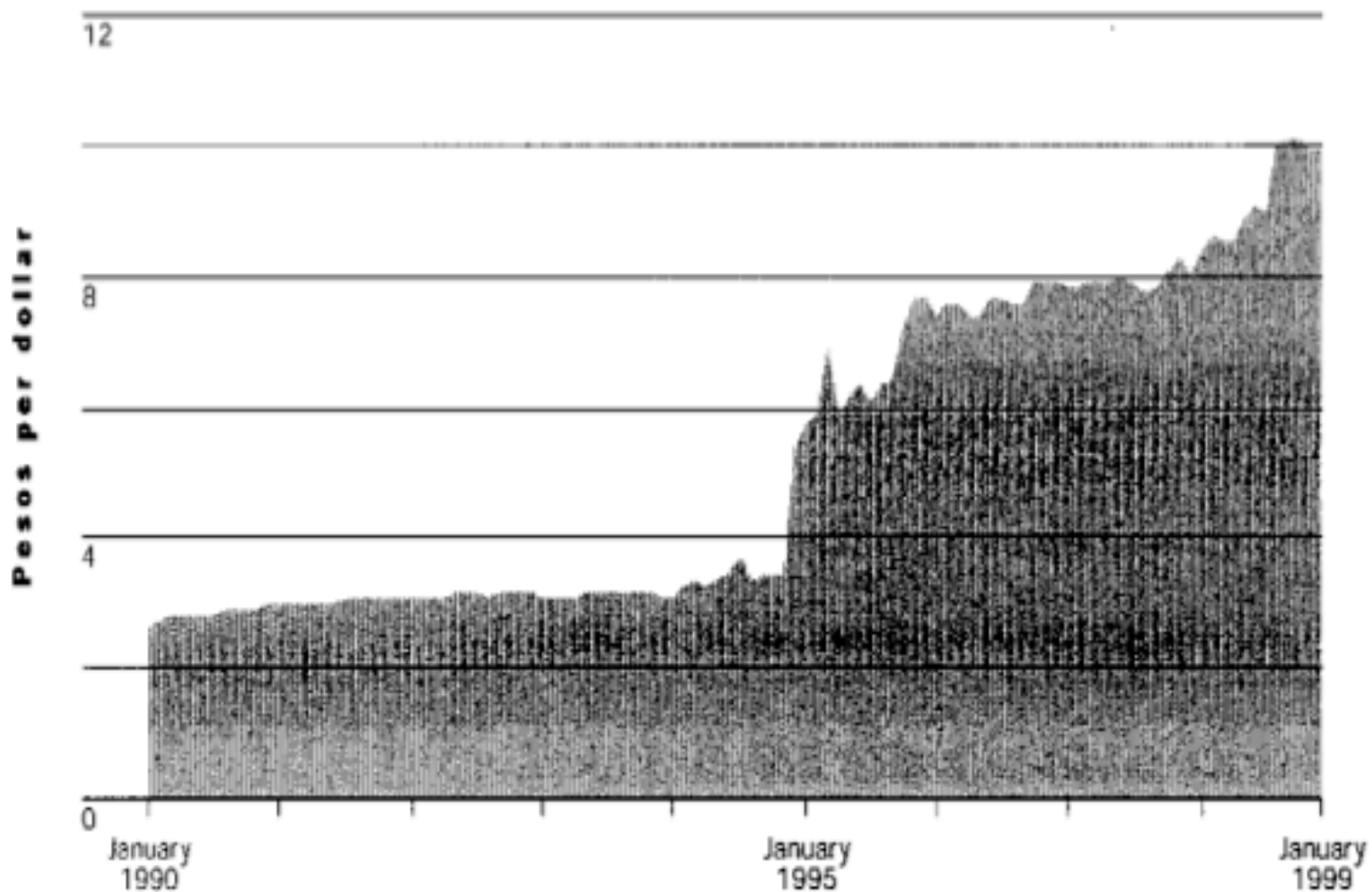


Figure 5: Peso – Dollar Exchange Rate, 1990-1998



The 1990s crises II

II. Thailand in 1997

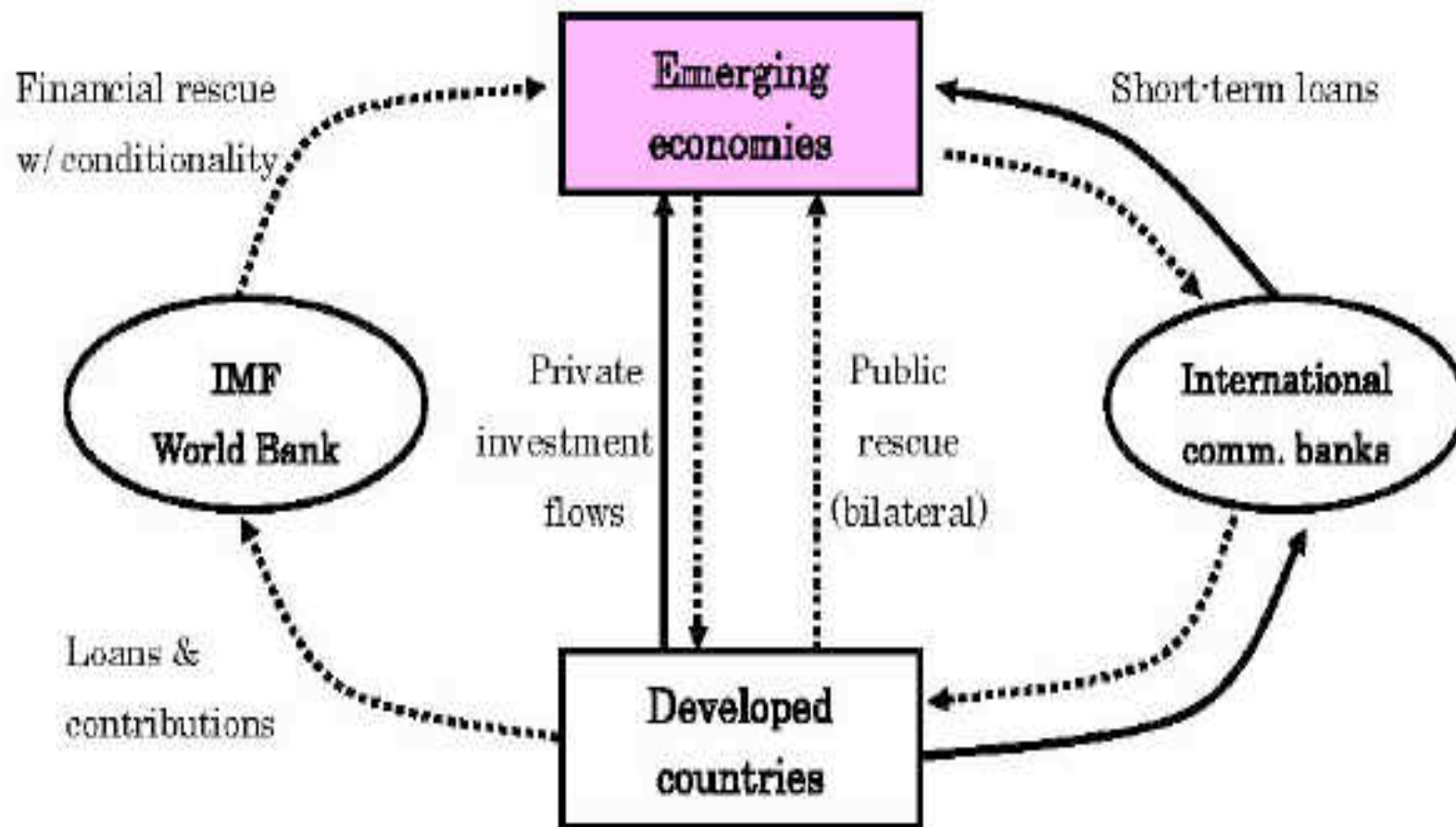
- Contagion to other East Asian countries
 - Preceded by very strong foreign capital inflows in East Asian countries in 1992-1997
- (1) Not only Western bank loans, but also portfolio investment in shares and bonds
 - (2) The foreign capital flowed mainly to the private sector (e.g. borrowing by East Asian banks and companies)

East Asian countries heavily hit by the 1997 crisis



The 1990s crises II

1990s: Private Overborrowing and Reversal



Note: solid lines are before crisis; dotted lines are after crisis.

The 1997 East Asian crisis I

- Currency mismatch

- East Asian banks and companies had borrowed in US\$ but their earnings were in the respective national currencies (for example, in Korean won)

- This was OK only until the fixed exchange rate regime (won – US\$) existed 固定相場制

- Maturity mismatch

- East Asian banks and companies borrowed short-term but lent/invested long-term

- This was OK only until foreign lenders/investors had confidence in them 外国人投資家の信頼

The problem of “original sin”

- Developing countries’ inability to borrow internationally in their own currencies (Barry Eichengreen and Ricardo Hausmann, 1999)

The 1997 East Asian crisis II

- Crisis in investor confidence → huge foreign capital outflows from East Asian countries
- Started in July 1997 with a speculative attack on the Thai currency (the baht) → baht depreciation
- What happened later was close to *the “twin crises” model* (e.g. currency depreciation and banking crises)
- The prospect of external debt default by the private sector (different from the debt crisis of the 1980s)

The 1998 Russian financial crisis I

- Started in August 1998
- **Main causes**
- (1) contagion from the 1997 East Asian crisis
- (2) decline in tax revenues partly due to the fall of world commodity prices → larger budget deficit
- (3) political instability
- **But the crisis was also triggered by sudden capital outflows**

The 1998 Russian financial crisis II

Some pre-crisis history

- (1) to control the high inflation in the early 1990s, in 1995 **Russia adopted a fixed exchange rate with a band**
- Before the crisis of August 1998, the ruble – USD exchange rate was 6.29 rubles/USD and the band was 5.3 – 7.1 rubles/USD
- (2) to finance its large fiscal deficit, **the Russian government issued huge amounts of short-term government bonds (the GKO) at high interest rates**
→ large foreign capital inflows

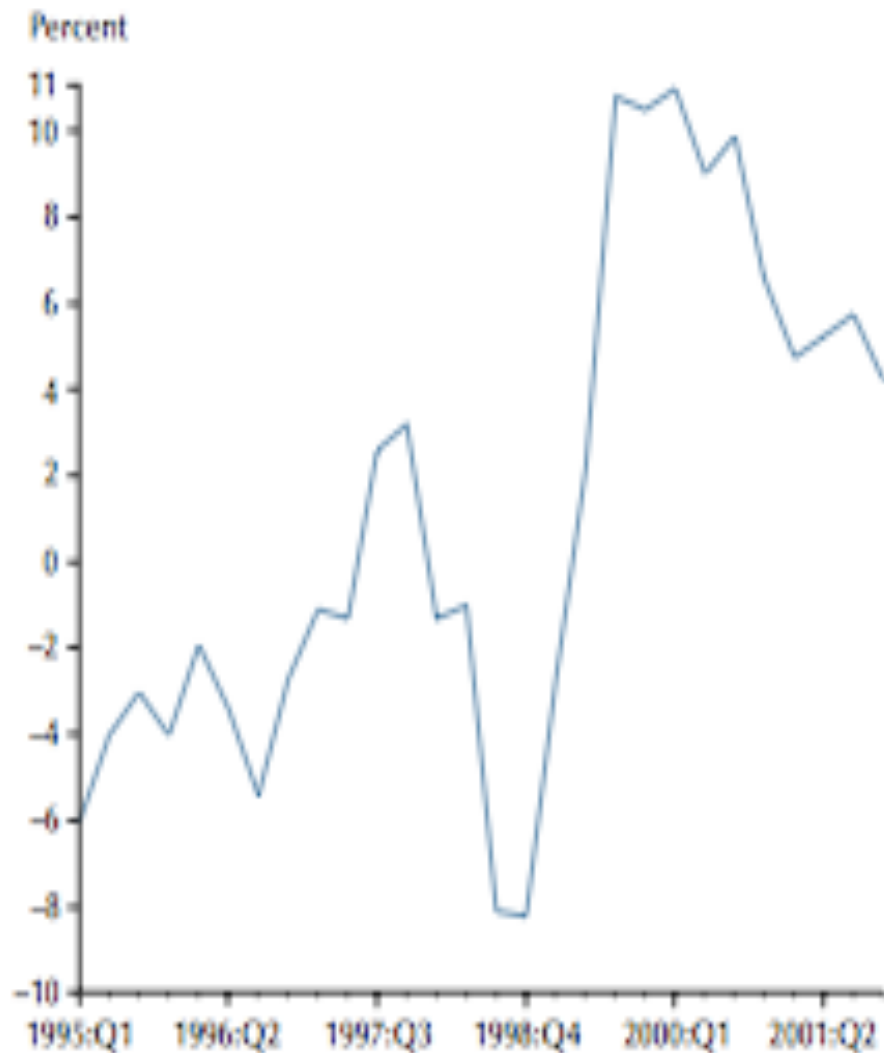
The 1998 Russian financial crisis III

- Crisis in investor confidence → massive selling of rubles and Russian assets (stocks, bonds) since June 1998 → huge foreign capital outflow
- **Some results**
- (1) the fixed ER was abandoned and the ruble depreciated rapidly to 21 rubles/USD
- (2) the Russian government announced a domestic and external debt default
- (3) many banks went bankrupt and were closed down

GDP decline and ruble depreciation

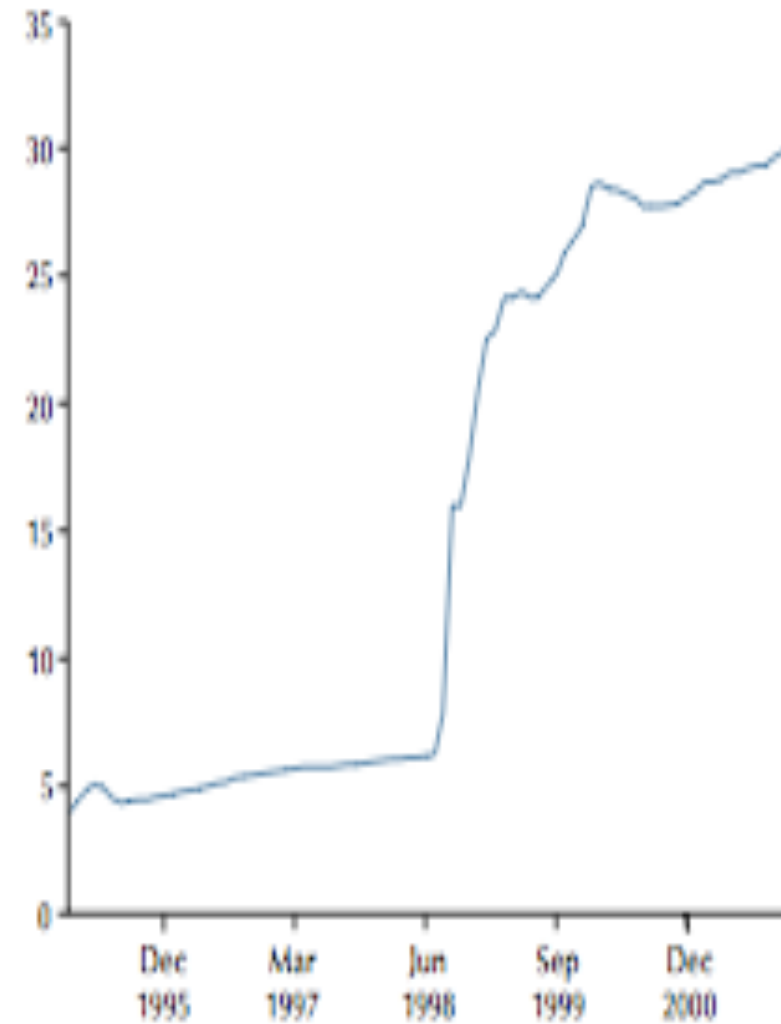
Real GDP Growth

Quarterly Change from Previous Year



Exchange Rate

Ruble/US\$



Questions for discussion

- Pros and cons of trade and financial openness for emerging economies
- Pros and cons of capital controls
- Similarities and differences between financial crises in the 1980s and the 1990s
- Can we predict financial crises and how (what kind of indicators could be useful)?

Assignment #4 (for 6 Dec.)

- I. Please find data on and analyze the FDI inflows of the country of your choice between 2008 and 2010
 - (1) the amount of FDI inflows in US dollars and as a percentage of GDP
 - (2) the composition of FDI inflows
 - (3) the countries from which FDI inflows originate
 - (4) the legal and business environment for FDI (e.g. factors that promote and/or hinder FDI inflows)
- II. Please describe briefly a case study of a successful FDI in the country of your choice.
- Please e-mail me the file until 6 pm on 5 Dec. (Mon.) and prepare a short talk about your assignment.