Econ 340

Lecture 20
International Policies for Economic Development: Financial

Announcement

- Course evaluations are now available. Please do yours for this course.

Lecture 20 Outline: International Policies for Economic Development: Financial

- The Issues
- Choice of Exchange Rate Regime
- Pros and Cons of Free Capital Movements
  – Debt Problem of the 1980s
  – The Asian Crisis of 1997
  – Capital Controls
- (How) Should Others Help?
- The World Financial Crisis and Developing Countries

The Issues

- Questions for Developing Countries Themselves
  - How to manage exchange rate
  - Whether to restrict capital flows
- Questions for Others, regarding Developing Countries
  - Pros and Cons of
    - Foreign Aid (next lecture)
    - Bailouts of countries
    - Debt Forgiveness
    - World Bank Lending

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Choice of Exchange Rate Regime

- Problems
  - Floating rate:
    - Temptation to inflate

      (This has led countries to use a pegged rate instead, using the peg as an “anchor” to lock in low inflation)
  - Pegged rate:
    - Tendency to become overvalued (because they are tempted to have inflation anyway)
    - Subject to exchange-rate crises

Choice of Exchange Rate Regime

- There is no easy answer
  - My recommendation: combination of
    - Floating exchange rate
    - Responsible monetary policy
      - How can this be assured?
      - Independent central bank

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Pros and Cons of Free Capital Movements

- Efficiency Gains
  - If return to capital in developing countries is higher than in developed countries
    - Then capital <u>should</u> flow into them
    - Gains are analogous to the gains from trade and gains from migration
      - (You) Could draw supply and demand curves for capital in two countries.
      - Measure the effects (gains and losses) of capital flows as we did for migration.

Pros and Cons of Free Capital Movements

- Costs of international capital movements (See Crook)
  - Capital markets are more prone to mistakes than goods markets: values depend on the future, which is hard to know
  - The use of “leverage” (borrowing to finance a purchase) increases risk (borrowers can gain more, but can also lose more than the value of their own wealth)
  - Borrowing across currencies adds additional risk of exchange-rate change
  - All these create a potential for crisis that does not arise with trade in goods

Pros and Cons of Free Capital Movements

- Vulnerability to Crisis
  - Some capital is <u>very liquid</u>

    (“Liquid” means “readily converted into cash”)
    - Bonds can be sold
    - Bank deposits can be withdrawn
  - Liquid capital that flows into a country may just as easily flow back out, if investors fear
    - Default (nonpayment by debtors)
    - Exchange Depreciation (reducing value of loan or ability to repay)
  - If that happens, a developing country that relied on foreign capital is suddenly in big trouble.
  - This has happened repeatedly:
    - The debt problems of the 1980s
    - The Asian crisis of 1997
    - Greece et al. in 2010-12-?; Cyprus 2013

We’ll look more at these

Clicker Question

What is the best choice of exchange regime for developing countries?

a) Pegged exchange rates because they permit monetary policy

b) Pegged exchange rates because they lead to overvaluation

c) Floating exchange rates because they fight inflation

d) Floating exchange rates because they reduce uncertainty

✓ e) There is no best choice for all developing countries

Clicker Question

Which of the following is <u>not</u> one of the drawbacks of free international capital movements?

a) Bank deposits can be withdrawn too easily

✓ b) Capital is likely to flow to countries where the return is higher

c) Capital that flows in can just as easily flow out

d) People borrow to finance their holdings, increasing risk

e) Capital markets are more prone to mistakes than goods markets

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Debt Problem of the 1980s

- Sources of the Problem
  – Developing countries' interest rates are normally high, for two reasons:
    - Productivity of capital is high because it is scarce
    - Development projects are risky, so borrowers pay a premium
  – To deal with resulting shortage of investment, developing-country governments either
    - Did the borrowing from abroad themselves, or
    - Guaranteed the loans to private borrowers

Debt Problem of the 1980s

- Sources of the Problem
  - The Role of Oil
    - Oil prices rose in the 1970s
    - OPEC (=Organization of Petroleum Exporting Countries)
      - Earned dollars for their oil
      - Made loans to develop<u>ed</u> countries
      - Develop<u>ed</u> countries, in turn, made loans to develop<u>ing</u> countries

        Called “recycling petrodollars”
    - Result: Developing-country debt grew very large by the end of the 1970s

Debt Problem of the 1980s

- Sources of the Problem
  - Servicing debt became harder in the 1980s, due to
    - Recession of 1980-81
      - Which reduced exports
    - Appreciation of the US dollar
      - A problem because debts were denominated in dollars
    - Developing country inflation and resulting currency overvaluation

Debt Problem of the 1980s

- Who did this happen to?

  Latin America, especially
- How did they deal with it?

  "Rescheduling loans"

  (= reducing payments)
- Effect afterwards: Made it more difficult for them to borrow afterwards, hurting their investment and growth for many years
  - The "Lost Decade" of the 1980s.

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The Asian Crisis of 1997

- Who experienced the Asian crisis, and when:

Country	Currency	When crisis hit
Thailand	Baht	Jul 1997
Philippines	Peso	Jul 1997
Malaysia	Ringgit	Oct 1997
S. Korea	Won	Nov 1997
Indonesia	Rupiah	Dec 1997

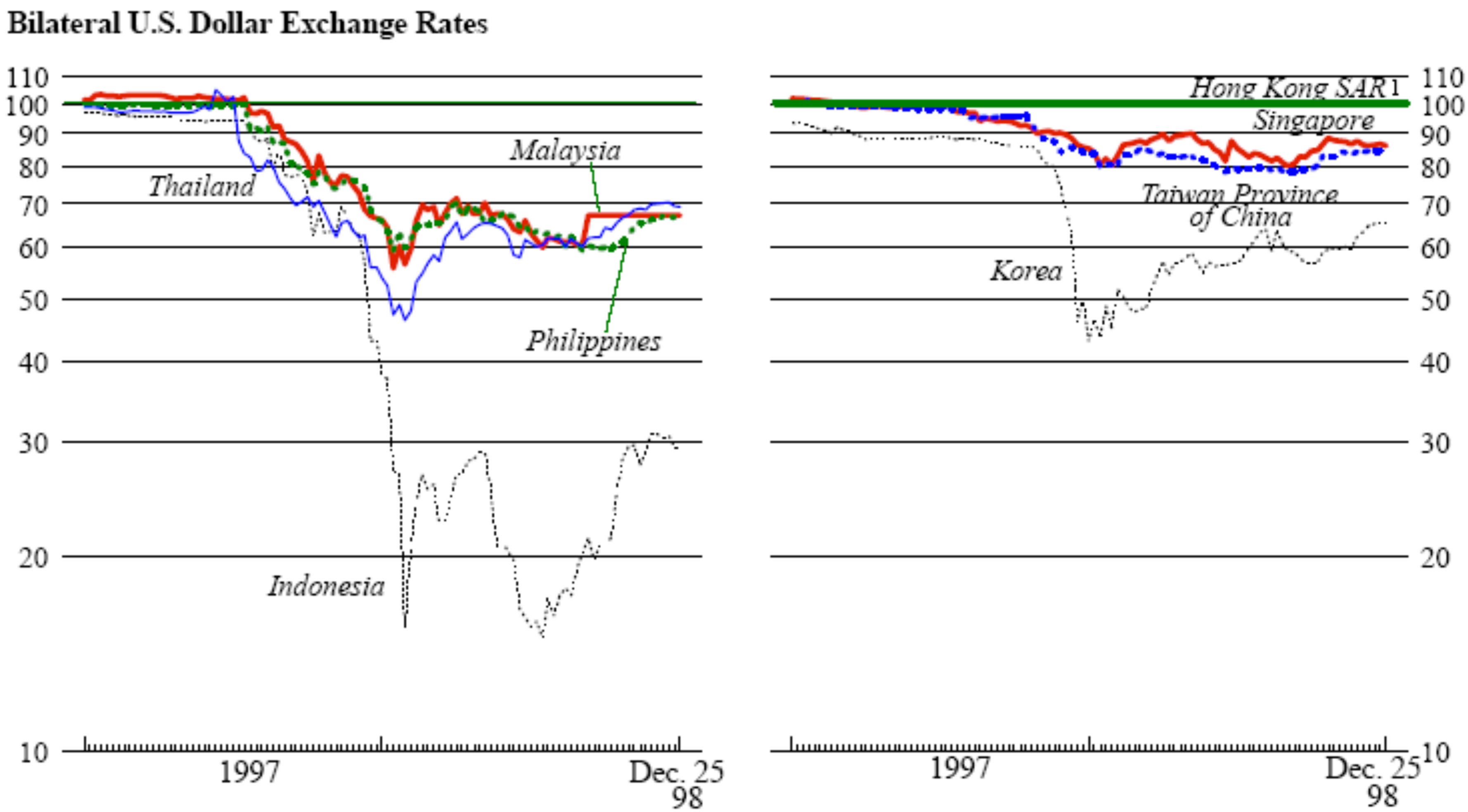
The Asian Crisis of 1997

- Characteristics of countries before the crisis
  - Mostly pegged exchange rates
  - Open capital markets
  - Current account deficits, but not large
  - Rapidly growing economies
  - <u>Not</u> particularly irresponsible fiscally

The Asian Crisis of 1997

- What happened
  - Loss of confidence in their currencies
    - Capital outflows
    - Speculative attack
    - Devaluation
    - Recession

The Asian Crisis of 1997



The Asian Crisis of 1997

- What has happened since (See Kharas)
  - Rapid recovery: pre-crisis levels of income were regained…
    - …by 1999 in Korea, Malaysia, and Philippines
    - …by 2003 in Thailand and Indonesia, who had been hit hardest.
    - This is faster than the recovery from the earlier Latin American debt crisis, which took a decade
  - Exports led the recovery

The Asian Crisis of 1997

- What has happened since
  - The countries have changed a lot
    - They are now more open (tariffs now less than 5%)
    - Shift from diversification to specialization
    - More integrated with the regional economy (i.e., China)
    - More
      - R&D
      - Educated workers
      - Urban
    - Financing shifted from banks to capital markets

The Asian Crisis of 1997

- What has happened since
  - There are, however, stresses
    - Rapid migration
      - Not to the largest cities
      - But to small and medium cities
    - Politics in these cities can’t keep up
      - They lack local officials with experience
      - Result is corruption

Clicker Question

What role did oil play in the contributing to the debt problems of developing countries in the 1980s?

a) They had to borrow in order to afford the oil they needed
b) Oil contributed to global warming, which reduced their incomes
✓ c) Profits from oil were lent through rich country banks to governments of developing countries
d) Borrowers in the private sector used oil as collateral for loans
e) The drop in the price of oil impoverished many developing-country oil producers

Clicker Question

Which victim of the Asian Crisis of 1997 experienced the greatest fall in the value of its currency?

✓ a) Indonesia

b) Malaysia

c) Thailand

d) S. Korea

e) Hong Kong

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Capital Controls

- Definition: Capital Controls = government restrictions on financial transactions, into and/or out of the country
  - Or, from Forbes: "various laws and regulations that restrict foreign investment in such areas as stock markets, banks and domestic firms"

Capital Controls

- Arguments in favor:
  - Reduce liquidity and prevent crises.
  - Prevent "contagion" (speculative attacks prompted by crises in similar countries)
  - Infant industry protection for financial firms
  - Free governments to pursue needed financial reforms

Capital Controls

- Costs (see Forbes):
  - Increase financing costs for domestic firms.
  - Induce market-distorting behaviors to avoid the costs of controls, or evade them.
  - Insulate markets from competition
  - Difficult and costly to enforce
  - In Chile: caused investment in small companies to plummet
- Whom do they hurt most? Small firms, who suffer from shortage of capital

Capital Controls

- Arguments against:
  - Deprives firms of ability to borrow, and/or raises the cost to them of borrowing
  - Protects inefficient firms, much like tariffs

Clicker Question

Which is <u>not</u> one of the arguments in favor of capital controls?

a) They reduce liquidity and prevent crises.
b) They prevent “contagion” (speculative attacks prompted by crises in similar countries)
c) They provide infant industry protection for financial firms
✓ d) They insulate markets from competition
e) The permit governments to pursue needed financial reforms

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(How) Should Others Help?

- Bailouts

  = give country money when a crisis occurs or looms.

  – Pro: Avoid crisis, and the resulting harm

  – Con: Discourages reforms that could prevent future problems

    - Countries come to expect bailout

      – Moral hazard = tendency to act more irresponsibly when adverse consequences are known to be reduced

(How) Should Others Help?

- Debt Forgiveness (see Krueger & Srinivasan)

  = Cancellation of old debts

  - Pro: Reduces burden on poor countries
  - Con: Discourages future lending to poor countries

(How) Should Others Help?

- World Bank Lending (see Lerrick)
  - In the past
    - WB could borrow on much better terms than developing countries
    - It therefore borrowed and made low-interest loans to them
    - It also imposed onerous requirements on them, called “technical assistance”

(How) Should Others Help?

- World Bank Lending (see Lerrick)
  - Now
    - Developing country credit ratings have improved
    - Technical assistance discourages them from using WB
    - WB still makes loans, but persuades develop<u>ed</u> countries to pay the interest

(How) Should Others Help?

- World Bank Lending
  - Lerrick (and others) say WB should
    - Stop lending at all
    - Make grants, not loans, to countries whose credit is weak

Clicker Question

What is moral hazard?

a) The loss of competitiveness that occurs when firms that have borrowed are unable to pay back their loans

b) The risk that illegal drugs may be smuggled inside of legal imports

✓ c) The tendency to act more irresponsibly when adverse consequences are known to be reduced

d) The possibility that a currency will fall in value instead of rise

e) The possibility that a currency will rise in value instead of fall

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The World Financial Crisis and Developing Countries

- The World Financial Crisis of 2008
  - Effects of crisis:
    - Spread to developing countries, pushing many back into poverty
    - Growth slowed, falling behind population growth
    - Rising joblessness and closed factories
    - Capital flows into developing countries declined
    - Decline in commodities prices (hurt some, helped others)

The World Financial Crisis and Developing Countries

- Effects were not just due to fall in demand or supply, but due to lack of availability of credit.
- Even oil exporters were hurting:
  - Drop in oil price
  - Many had borrowed heavily, and loans are hard to roll over
- However, unexpectedly, many developing countries
  - Had income decline less than developed countries
  - Recovered more quickly
  - Since then have often helped others to recover

Clicker Question

Which of the following is **not** one of the reasons given by Krueger and Srinivasan, in their article "The Harsh Consequences of Forgiveness," for not forgiving the debts of the heavily indebted poor countries?

a) Not all poor countries are heavily in debt, yet they too need help
b) Past episodes of debt relief have not benefited the poor
c) Direct use of resources to benefit the poor is more likely to help them
✓ d) Poor countries must help themselves, not rely on others, in order for their progress to be lasting
e) High debts are often the result of misguided government policies in the past, which are likely to be repeated

Next Time

- International Policies for Economic Development: Aid
  - Why Should We Care?
  - Who Gives Aid?
  - Does Aid Work?
  - Pros and Cons of Aid
  - Policy Recommendations