Econ 340
Lecture 20
International Policies for Economic Development: Financial
Questionnaire Results
Difficulty

[Bar chart showing difficulty levels: Way too easy, Too easy, Just right, Too hard, Way too hard]
Pace

- Way too slow
- Too slow
- Just right
- Too fast
- Way too fast
Content
Math

- Way too little math
- Too little math
- Just right
- Too much math
- Way too much math
Aspects of the course

<table>
<thead>
<tr>
<th>#</th>
<th>Field</th>
<th>Not used</th>
<th>Useless</th>
<th>Useful</th>
<th>Very useful</th>
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## Aspects of the course

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Year

- Freshman
- Sophomore
- Junior
- Senior
- Other (specify)
Grade

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<td>C</td>
<td>24-26</td>
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<td>D or E</td>
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Missed exam due to: 0-26
Why?

- Needed credits to graduate
- Needed credits for Econ major
- Needed for other major (please specify)
- To raise GPA
- Like B:30 classes
- Interested in international economics
- Other (please specify)
Announcement

• I will not be holding my usual office hour tomorrow (Thursday, Apr 6), as I will be out of town. My next office hour will be next Monday, Apr 10, at 10:00.
Lecture 20

• 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 should 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) from 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 very liquid
    (“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
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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 developed countries
      – Developed countries, in turn, made loans to developing 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:

<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
<th>When crisis hit</th>
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</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>Baht</td>
<td>Jul 1997</td>
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<tr>
<td>Philippines</td>
<td>Peso</td>
<td>Jul 1997</td>
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<tr>
<td>Malaysia</td>
<td>Ringgit</td>
<td>Oct 1997</td>
</tr>
<tr>
<td>S. Korea</td>
<td>Won</td>
<td>Nov 1997</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Rupiah</td>
<td>Dec 1997</td>
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</tbody>
</table>
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
  – Not particularly fiscally irresponsible
The Asian Crisis of 1997

• What happened
  – Loss of confidence in their currencies
    • Capital outflows
    • Speculative attack
    • Devaluation
    • Recession
The Asian Crisis of 1997

Bilateral U.S. Dollar Exchange Rates

[Graph showing exchange rates for Thailand, Malaysia, Philippines, Hong Kong SAR, Singapore, Taiwan Province of China, and Korea from 1997 to December 1998]
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
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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
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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)
  – Until recently
    • 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 developed 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
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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
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