

CHAPTER 15

Developing Countries and International Finance II: The Global Capital Flow Cycle

Global investors became nervous in the summer of 2017 in the face of discussion about tightening monetary policy in the United States and European Union. At the center of investor concern was the fear that tighter policy in the U.S. would spark a substantial outflow of capital from emerging markets. Large and sustained capital outflows would force governments in emerging market economies to raise interest rates, erode their accumulated foreign exchange reserves, and possibly spark currency crises and broader balance-of-payments crises. Such fears arose in the summer of 2017 because memories of the way markets reacted to the U.S. decision to tighten monetary policy in 2013 and 2014 remained fresh. In that period, stock markets in emerging economies fell and interest rates rose sharply as investors shifted back into dollar-denominated assets in response to rising interest rates in the U.S. The episode angered many emerging market policymakers, who accused the Federal Reserve of showing little concern for how its policy affected emerging market economies.

This episode constitutes the most recent manifestation of a broader dynamic in the global financial system, called the global capital flow cycle, that has come into sharp relief since 1990. The global **capital flow cycle** is characterized by two central components. One component is a two-phase cycle in the distribution of cross-border capital flows. In one phase, financial capital flows into emerging market economies in large volumes, where it strengthens currencies and inflates asset prices. In the second phase, investors sell their emerging market assets in favor of

dollar-denominated assets, thereby depressing asset prices, raising interest rates, and creating the risk of banking and currency crises. The second component is the role of American monetary policy in shifting the cycle from one phase to the other. When interest rates fall in the U.S., capital flows to emerging markets in search of higher returns. When interest rates in the U.S. rise, capital flows out of emerging markets and back into dollar-denominated assets. American policy thus generates a capital flow cycle that increases financial volatility in the emerging market economies.

Although this global capital flow cycle was an important factor in the evolution of the Latin American debt crisis, the cycle has become more pronounced since 1990. Since 1990, the capital flow cycle has gone through two full rotations. The first rotation began in the early 1990s with large and sustained capital inflows to a small number of Asian economies, Argentina, Brazil, Mexico, Russia, and Turkey. This phase of the cycle ended with a series of crises that began in the late 1990s and widespread calls for reform of the global crisis management regime. The second revolution began in the wake of the 2008 U.S.-centered financial crisis as loose monetary policy in the U.S. encouraged investors to search for higher returns in emerging market economies. The shift to a more restrictive monetary policy in the U.S. since 2014 has created substantial volatility for emerging markets, but has not yet produced a major banking or currency crisis. The challenges governments face in managing their economies in the face of the volatilities generated by this capital flow cycle has caused the International Monetary Fund to become more forgiving of capital controls.

We examine this global capital flow cycle in this chapter. We look first at the series of crises that struck during the 1990s, focusing deeply on the largest of them: the 1997 Asian crisis. We then examine how that crisis subsequently prompted considerable discussion about reforming the international financial system in order to alter how crises are managed and to try to reduce the frequency of such crises in the future. We then look at the most recent revolution of the cycle, which began in the wake of the U.S. financial crisis of 2008. The chapter concludes by drawing some more general lessons.

THE ASIAN FINANCIAL CRISIS

The first revolution of the global capital flow cycle occurred between 1990 and 1999. Developing countries attracted little new private capital during the 1980s. It was not until the end of the decade and after reform had taken

root that private capital began flowing again. Private capital flows resumed in a changed environment, however. On the one hand, policies toward private capital flows were radically different. Although most governments had restricted capital flows in connection with import substitution, many dismantled these controls in connection with policy reforms implemented during the 1980s and early 1990s. Consequently, it became much easier for private individuals to move capital into and out of emerging markets. On the other hand, financial liberalization in advanced industrialized countries had increased the importance of securities—stocks and bonds—as sources of financing. The growing importance of nonbank capital flows was reinforced by the lingering effect of the Latin American debt crisis: few banks were willing to lend to countries that had so recently defaulted.

These changes combined to alter the composition, as well as the scale, of private capital flows to the developing world. The importance of commercial bank lending diminished, whereas that of bond and equity flows increased. Most private capital flows to Latin America during the 1990s, for example, financed government and corporate bonds and purchased stocks in newly liberalized stock markets. By the mid-1990s, private capital flows to the entire developing world had risen to about 3 percent of these countries' gross domestic product (GDP) (see [Figure 15.1](#)). Asia was the largest recipient of capital inflows prior to 1997, accounting for almost 50 percent of total flows to all developing countries in the first half of the decade. Latin America was the second-largest recipient, obtaining between one-quarter and one-third of all flows to developing countries (IMF 2000).

The resumption of private capital flows generated one crisis after another. The growing importance of bond and equity flows, often referred to as **hot money** because it can be withdrawn at the first hint of trouble, increased the volatility of private capital flows to these “emerging market” countries. Although developing countries have struggled with such volatility throughout the last 100 years, volatility increased during the 1990s compared with earlier periods (IMF 2001, 163; World Bank 2001a). Historical evidence suggests that more volatile capital flows have been associated with lower economic growth rates over the long run (World Bank 2001a, 73). In addition, the record of the 1990s indicates that increased volatility of private capital flows is associated with more frequent financial crises that substantially reduce economic growth for a year or two.

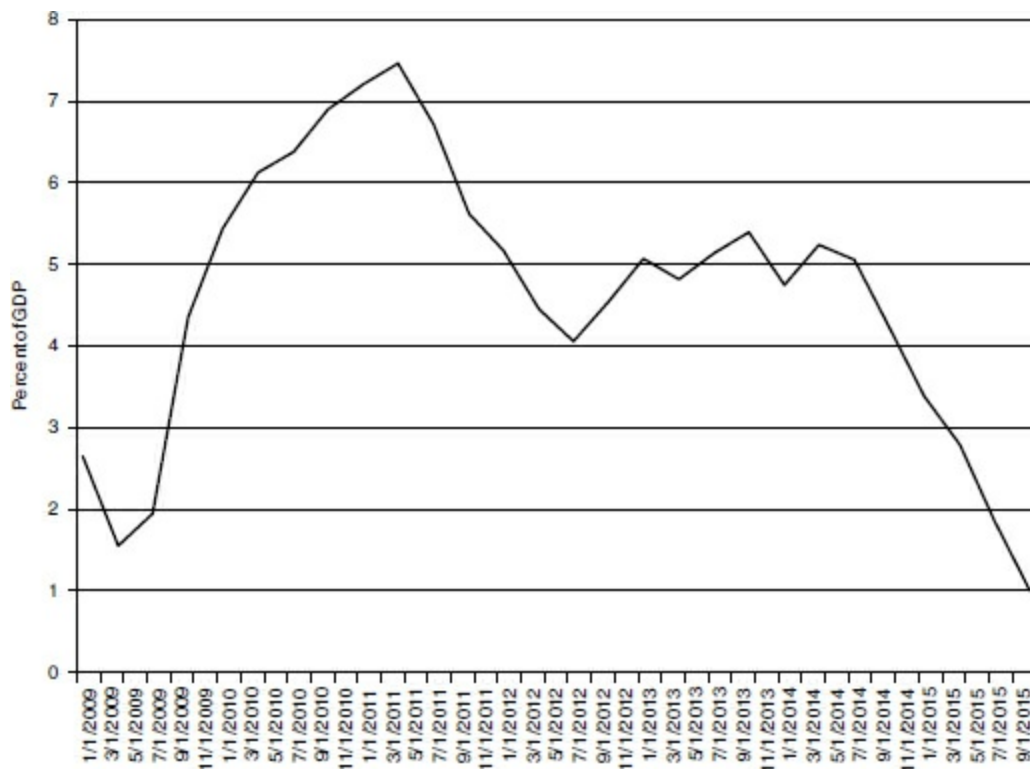


FIGURE 15.1

Gross Private Capital Inflows to Emerging Market Economies, 2009–2015

Note: Excludes foreign direct investment flows.

Sources: Clark et al., 2016; World Bank, *Global Development Finance 2004 CD-Rom*, Table 1.1 (Washington, DC: World Bank Publications, 2004); World Bank, *Global Development Finance 2005 CD-Rom*, Table 1.1 (Washington, DC: World Bank Publications, 2005) and World Bank, *Global Development Finance 2008 CD-Rom*, Table 1.1 (Washington, DC: World Bank Publications, 2008).

Such financial crises became all too common during the 1990s. Mexico experienced the first one in late 1994. Four Asian countries—Indonesia, Malaysia, South Korea, and Thailand—had severe crises in the summer and fall of 1997. Brazil and Russia both experienced crises in 1998. Turkey and Argentina were struck by crises in 2000 and 2001. Each crisis was distinctive in some way, and yet all shared important similarities (see Table 15.1). First, each country struck by a crisis maintained some form of fixed exchange rate. In most instances, governments maintained a crawling peg or the slightly less restrictive crawling band. Second, each country developed a heavy reliance on short-term foreign capital.

The combination proved perilous. Heavy dependence on short-term capital required the continual rollover of foreign liabilities. The ability to roll over these liabilities depended critically on the government’s ability to maintain foreign investors’ confidence in its commitment to the fixed exchange rate. In each crisis, foreign investors lost confidence in that

commitment. The trigger for crisis varied. Sometimes it was a political shock, as in Mexico; sometimes it was an economic shock, as in Russia and Argentina; sometimes it was contagion from crises in other regions. In all instances, however, the evaporation of foreign investors' confidence in the government's commitment to the fixed exchange rate triggered massive capital outflows that forced governments to devalue and (with the lone exception of Brazil) pushed the country into deep economic crisis. In many instances, the economic crisis toppled governments as well.

The Asian financial crisis of 1997 provides the clearest illustration of the challenges these countries faced. The Asian crisis originated in political and economic dynamics in four countries: Thailand, Indonesia, South Korea, and Malaysia. During the late 1980s and early 1990s, the government in each country liberalized their financial markets to make it easier for domestic banks and firms to borrow on international financial markets. In Thailand, for example, the government created the Bangkok International Banking Facilities in 1992 in an attempt to make Thailand an Asian banking center. The government hoped that Thai banks would borrow on international markets and then lend the funds obtained to borrowers across Asia. Financial liberalization thus enabled Asian banks to intermediate the flow of funds from international lenders to domestic borrowers. The incentive for such intermediation was powerful. Interest rates in international markets were considerably lower than interest rates inside Asian economies. Asian banks could thus borrow money at a relatively low rate of interest, such as 9 percent, from foreign commercial banks and then lend it to domestic borrowers at a much higher rate of interest, such as 12 percent.

TABLE 15.1

A Chronology of Crises, 1994–2002

Mexico (December 1994–January 1995)

Exchange Rate: Crawling band pegged to the dollar.

Financing Problem: The Mexican government began issuing short-term debt linked to the U.S. dollar in April 1994 (*Cetes*, analogous to U.S. Treasury bonds) to reduce its interest rate. The value of the *Cetes* issued soon exceeded the central bank's foreign exchange reserves.

Trigger: Unrest in Chiapas province generated a speculative attack in early December.

IMF Support: Mexico secured credits for \$48.8 billion, including

\$17.8 billion from the IMF and \$20 billion from the U.S. government.

Fallout: The government devalued the peso by 15 percent on December 20 and then floated the peso on December 22. The peso depreciated from 3.64 per dollar to more than 7 per dollar. Mexico suffered a depression and severe banking problems that prompted government rescues.

Contagion: Speculative attacks spread throughout Latin America and Asia.

East Asia (July 1997–January 1998)

See details in this chapter.

Russia (August 1998)

Exchange Rate: Crawling band pegged to the dollar.

Financing Problem: The Russian government was paying very high interest rates on large short-term debt.

Trigger: Falling prices for oil (the country's major export) and weak growth generated speculative attacks. The government widened the *ruble's* band by 35 percent in August and then floated the *ruble* in early September. The *ruble* depreciated from 6.2 per dollar to more than 20 per dollar.

IMF Support: Russia secured IMF credits of \$11.2 billion in July 1998.

Fallout: The government defaulted on its ruble-denominated debt and Soviet-era foreign debt and imposed a moratorium on private-sector payments of foreign debt. The economy fell into recession. Many Russian banks became insolvent.

Contagion: Speculative attacks spread to Latin America, hitting Brazil especially hard. The U.S. hedge fund Long Term Capital Management was pushed to the brink of bankruptcy and was rescued in an effort coordinated by the Federal Reserve Bank of New York.

Brazil (January 1999)

Exchange Rate: Crawling band pegged to the U.S. dollar.

Financing Problem: Growing government debt and a sizable current-account deficit generated large short-term external debt.

Trigger: The Russian crisis and the subsequent collapse of Long Term Capital Management generated speculative attacks between August and October of generated speculative attacks between

August and October of 1998. Attacks resumed in early 1999 when a state government defaulted on payments to the federal government. The *real* was devalued by 9 percent on January 13, 1999, and then floated on January 18. The currency depreciated from 1.21 per dollar to 2.18.

IMF Support: Brazil secured an IMF credit of \$18 billion on December 2, 1998.

Fallout: Mild; growth strengthened in 1999 and 2000. The financial system suffered little.

Contagion: Brazil's devaluation contributed to recessions in Argentina and Uruguay and generated speculative attacks that forced Ecuador to float in February 1999.

Turkey (February 2001)

Exchange Rate: Crawling peg against the dollar and the German mark.

Financing Problem: Large government short-term debt and a large current-account deficit generated heavy dependence on short-term foreign capital.

Trigger: Concern about a criminal investigation into ten government-run banks in late November 2000 generated a speculative attack. Eight banks became insolvent and were taken over by the government. Investors lost confidence in February 2001 when conflict between the president and prime minister weakened the coalition government. The government floated the lira on February 22, and it depreciated from 668,000 per dollar to 1.6 million per dollar by October 2001.

IMF Support: Turkey secured an IMF credit of \$10.4 billion on December 21.

Fallout: The Turkish economy contracted by 7.5 percent in 2001.

Contagion: None.

Argentina (2001)

Exchange Rate: Fixed to the U.S. dollar.

Financing Problem: Large government short-term debt.

Trigger: Speculative attacks against this peg emerged in 2000 and continued sporadically into 2001. The government introduced some exchange-rate flexibility in mid-2001, generating new speculative attacks. The government floated the peso in January 2002 and defaulted on its foreign debt.

IMF Support: Argentina secured a total of \$40 billion in credits from the IMF and the advanced industrialized countries.

Fallout: Argentina's economy collapsed into deep depression.

Contagion: None.

Sources: Compiled from information in Eichengreen 2001; Joint Economic Committee 2003; and material on the IMF website (www.IMF.org).

Such intermediation was risky. Asian banks contracted short-term loans denominated in dollars and other foreign currencies from foreign banks and then offered these funds as long-term loans denominated in the domestic currency to local borrowers. Asian banks thus confronted two kinds of risk. First, they faced exchange-rate risk, which arose from the possibility that the government would devalue the local currency. Were this to happen, the domestic currency cost of servicing the dollar-denominated loans would rise substantially. At the extreme, the domestic currency cost would rise above the payments that Asian banks were receiving from the businesses to which they had lent money. Asian banks were also exposed to the risk that foreign lenders would stop rolling over their short-term loans. Because Asian banks had borrowed on a short-term basis and then made long-term loans, they needed foreign lenders to renew the loans every 6 or 12 months. If foreign commercial banks became unwilling to rollover loans, Asian banks would be forced to repay all of their short-term debt at once. Yet, because these funds were tied up in the long-term loans that the Asian banks had made to local borrowers, the Asian banks would be unable to raise the funds needed to repay their debts to foreign banks.

The ability of Asian banks to intermediate safely between international and domestic financial markets was compromised by flaws in Asian countries' financial regulations. The central weakness was a problem called **moral hazard**, which arises when banks believe that the government will bail them out if they suffer large losses on the loans they have made. If banks believe that the government will cover their losses, they have little incentive to carefully evaluate the risks associated with the loans they make. If borrowers repay, banks earn money. If borrowers default, the government—and society's taxpayers—pick up the tab. In such an environment, banks have an incentive to make riskier loans than they would make in the absence of a promise of a government bailout. This incentive arises because banks charge higher interest rates to high-risk borrowers. As a result, higher-risk loans, when they are repaid, yield higher returns than low-risk loans. A government guarantee thus creates a

one-way bet for banks: lend heavily to risky borrowers and they will profit greatly if the loans are repaid, yet they will suffer little if they are not, because the government will bail them out. The danger is that the practice of lending heavily to high-risk borrowers makes a systemic financial crisis more likely. Banks will lend too much to risky borrowers, and too many of these high-risk borrowers will default. Banks will therefore lose money, forcing the government to step in and bail them out. The government guarantee thus makes a financial crisis more likely.

Moral hazard was particularly acute in many Asian countries. Financial institutions had close ties to governments, sometimes through personal relationships and sometimes through direct government ownership. In Indonesia, for example, seven state-owned banks controlled half of the assets in the banking system (Blustein 2001, 94), and relatives and close friends of Indonesian President Suharto controlled other financial institutions. In the past, such relationships had led governments to rescue banks and other financial institutions in distress. In Thailand, for example, the government rescued the Bangkok Bank of Commerce in 1996 at the cost of \$7 billion (Haggard 2000, 25). In Indonesia, two large corporate groups rescued Bank Duta (which held deposits from President Suharto's political foundations) after it had lost \$500 million in foreign exchange markets. The corporate rescuers were in turn rewarded by the Suharto regime (Haggard 2000, 26). Given this recent history, foreign and domestic financial institutions participating in the Asian market had reason to believe that Asian governments would not allow domestic financial institutions to fail. This belief in turn led international investors to lend more to Asian banks, and Asian banks to lend more to Asian businesses, than either would have been willing to lend had Asian governments not rescued banks in the past.

In principle, governments can design financial regulations to prevent the risky lending practices to which moral hazard so often gives rise. Banking regulation can limit the activities that financial firms engage in and thereby confine the overall risk in lending portfolios. In the Asian-crisis countries, however, such financial regulation was underdeveloped, and where it did exist, it was not effectively enforced. In Indonesia, for example, any regulator "who attempted to enforce prudential rules ... was removed from his position" (Haggard 2000, 33). Nor was this kind of treatment restricted to civil servants: the managing director of the central bank was fired in 1992, and the minister of finance was fired in 1996 (Haggard 2000, 33). As Haggard notes, the more general problem lay in the "influence that business interests exercised over legislation, regulation, and the legal

process” (Haggard 2000, 38). In other words, the same network of business–government relations that created the moral hazard problem in the first place also weakened the incentives that governments had to develop and enforce effective prudential regulations. As a consequence, there were few regulatory checks on the lending practices of Asian financial institutions.

This regulatory framework enabled Asian banks to accumulate financial positions that could not easily withstand exogenous shocks. Asian economies were hit by shocks in late 1996 and early 1997. First, Asian countries’ exchange rates began to appreciate against the Japanese yen in the mid-1990s. Most Asian governments pegged their currencies to the dollar. As the dollar appreciated against the yen in the mid-1990s, Asian currencies appreciated too. Exchange-rate appreciation made it difficult for domestic firms to export to Japan, one of their major export markets, which in turn created debt-service problems for export-oriented firms. Second, real-estate prices began to fall in late 1996, creating debt-service problems for real-estate developers. In March, the Thai government purchased \$4 billion of debt that property developers owed but were unable to pay to domestic banks. By 1997, therefore, many of the Asian banks’ largest domestic borrowers were struggling to service their debts. As a consequence, the number of non-performing loans—loans on which interest payments had not been made for 6 months or more—held by Asian banks began to grow. Because domestic borrowers could not repay domestic banks, the domestic banks could not easily repay foreign banks. Domestic debt-service difficulties thus began to generate international debt-service difficulties.

Weaknesses in Asian financial systems became a source of general concern in the spring of 1997. The trigger was the discovery that one of Thailand’s largest financial institutions, Finance One, was insolvent. The discovery caused foreign banks to look much more closely at banks throughout Asia. Close inspection indicated that Finance One’s situation was not unique; banks across Asia were facing similar problems as a result of appreciating currencies and popping real estate bubbles. Deteriorating conditions in Asian financial systems and shifting international market sentiment combined to produce a panicked withdrawal of funds from Asian markets in the summer of 1997. Foreign banks that had loaned heavily to Asian banks refused to roll over existing loans and demanded repayment of whatever loans they could. Funds also started flowing out of Asian stock markets.

The panic began in Thailand in May 1997, where it quickly consumed

the Thai government's foreign exchange reserves and forced the government to float the baht. The panicked withdrawal of funds from Asia over the next 6 months struck practically every country in the region. After their experience with Thailand, financial markets shifted their attention to the Philippines, forcing the government to abandon its fixed exchange rate after only 10 days. Attention shifted to Indonesia and Malaysia in July and August, and governments in both countries responded to massive capital outflows by abandoning their fixed exchange rates and allowing their currencies to float. From there, speculation targeted Taiwan, forcing a devaluation of the Taiwanese dollar, and Hong Kong, where capital flight caused the Hong Kong stock market to lose about one-quarter of its value in only 4 days. The crisis moved to South Korea in November, forcing the government to float the won by the middle of the month. A total of \$60 billion was pulled from the region in the second half of 1997, roughly two-thirds of all the capital that had flowed into the region the year before. An additional \$55 billion was pulled out in 1998 (IMF 1999, 92).

As the crisis struck, Asian governments turned to the IMF for financial assistance. The Philippines was the first to do so, gaining a \$1.1 billion credit on July 14. The Thai government turned to the IMF 2 weeks later and was provided \$16 billion from the IMF and other Asian countries. Indonesia held out longer, turning to the IMF only in October and receiving a \$23 billion package. South Korea received the most support from the international community, acquiring a \$57 billion package in early December. In all, the four hardest-hit countries—South Korea, Indonesia, Thailand, and Malaysia—received \$117.7 billion.

As in earlier crises, IMF assistance was conditional upon economic reform. The reforms incorporated into IMF conditionality agreements in the Asian crisis targeted three broad areas: macroeconomic stabilization, reform of the financial sector, and structural reform. Macroeconomic stabilization programs were necessary, the IMF argued, to restore market confidence in the crisis countries and to stem capital outflow. Governments tightened monetary policy to stem the depreciation of their currencies. They tightened fiscal policies to generate the financial resources needed to rebuild the financial sector. Finally, the IMF required Asian governments to implement structural reforms, including trade liberalization, elimination of domestic monopolies and other uncompetitive practices and regulations, and privatization of state-owned enterprises. In Thailand, structural reforms targeted the civil service and state-owned enterprises. In Indonesia, the IMF pressed the government to deregulate agriculture and reduce the monopoly position of the national

agriculture marketing board. The IMF pressed the Indonesian government to privatize 13 state-owned enterprises and to suspend the development of auto and commercial aircraft industries.

TABLE 15.2

Economic Growth and Current-Account Balances in Asia

	1995	1996	1997	1998
Economic Growth (annual percent change)				
Thailand	8.8	5.5	-0.4	-5.0
Indonesia	8.2	8.0	4.6	-13.7
South Korea	8.9	7.1	5.5	-5.8
Current-Account Balance (percent of gross domestic product)				
Thailand	-7.8	-7.9	-2.0	6.9
Indonesia	-3.2	-3.3	-1.8	1.6
South Korea	-1.9	-4.7	-1.9	7.3

Source: International Monetary Fund (IMF), *IMF Annual Report* (Washington, DC: IMF, 1999).

The crisis had severe economic and political repercussions. The financial crisis and macroeconomic stabilization precipitated deep recessions throughout Asia. Indonesia experienced the biggest downturn, with economic output contracting by more than 13 percent in 1998. In most countries, the economic crisis hit the poor the hardest, and as a consequence, poverty rates rose sharply. In Indonesia, the number of people living below the poverty line grew from 11 percent of the population to 19.9 percent in 1998. In South Korea, the poverty rate rose from 8.6 percent to 19.2 percent in 1998. Deteriorating economic conditions sparked protest and political instability. In Indonesia, economic crisis sparked large-scale opposition to the Suharto government's corruption, nepotism, and cronyism. As the crisis deepened, regime opponents demanded fundamental political reform and a reduction of basic commodity prices, particularly of energy and rice. Protests and opposition peaked in May 1998. Four students were killed by the military during an anti-Suharto demonstration at Triskati University, sparking even larger protests during the days that followed. By late May, Suharto had stepped

down from office.

The economic crisis sparked political change in Thailand as well. Thailand had begun constitutional reform in the early 1990s but had stalled under competing visions of how the new political institutions should be structured. Acceptance of the new constitution by the major societal groups was “propelled forward” by the economic crisis. As Haggard (2000, 94) notes, it is “highly doubtful that [this political reform] would have occurred in the way that it did in the absence of crisis circumstances.” In addition, the government that had presided over the economy in the years leading up to the crisis was unable to maintain a majority coalition. It was replaced in November 1997 by a new government based on a 5-party coalition dominated by the Democrat Party, the oldest political party in Thailand. The Democrat Party was “free of the more egregious patronage, pork-barrel spending, and corruption of its opponents” (Haggard 2000, 94). In Indonesia and Thailand, therefore, economic crisis provoked a reaction against the corruption of previous governments, mobilized societal support for far-reaching constitutional reform, and brought to power groups committed to economic and political reform.

A Closer Look

Cancelling the Debt for the World’s Poorest Nations

By the late 1990s, the world’s poorest countries, most of which are located in sub-Saharan Africa, owed about \$200 billion to foreign creditors. Most of this debt was owed to official lenders—to the World Bank and the IMF or to governments in the advanced industrialized world. Payments to service this debt in 1999 (before the latest debt-relief initiative had taken effect) amounted to slightly more than \$3 billion, a sum equal to 21 percent of government revenue and 15 percent of export earnings. The indebted countries are very poor. Roughly half of their combined population of 615 million people were living on less than \$1 per day, and for at least ten of these countries, per capita income in 1999 had fallen below the level of 1960.

Such heavy debt burdens depressed economic growth in sub-Saharan Africa. Facing large debt payments, governments were forced to devote a sizable share of their available domestic resources to debt service. Large debt burdens also make it impossible to attract new foreign capital. Private lenders are unwilling to lend to countries that are unable to service their existing debt, so private capital flows are not an option. Official lenders also are increasingly reluctant to offer

new loans. As the scale of the debt problem grew, the World Bank and the IMF, as well as many of the bilateral donors, became increasingly focused on restructuring existing debt rather than on providing new loans, and any new loans that were forthcoming were typically offered primarily to facilitate debt service. As a consequence, large debts essentially forced countries to forgo access to fresh foreign capital.

The creditor governments managed the African debt crisis by using essentially the same negotiation and rescheduling process that they had employed to manage the Latin American debt crisis. African governments negotiated stabilization and structural adjustment packages with the IMF and the World Bank, which then provided additional financial support, and existing debt was rescheduled. By the late 1980s, official creditors were concluding that the heavily indebted countries would never be able to repay their debts and that the level of debt service was having seriously deleterious consequences on those countries' economic performance. As this recognition took hold, creditor governments began to offer debt-reduction packages to the most heavily indebted poor countries.

The results from debt-reduction programs provided during the 1990s were disappointing. In spite of reducing foreign debt by around \$60 billion, debt-service burdens actually increased for the poorest countries (IMF 2000; Easterly 2002, 125–126). Consequently, and partly in response to pressure from a coalition of nongovernmental organizations and religious groups, the World Bank and the IMF launched the **Heavily Indebted Poor Countries (HIPC)** debt initiative in September 1996. The most novel aspect of the HIPC initiative was that, for the first time, creditors would reduce the debt owed to multilateral lenders. All previous debt-relief measures had focused on debt owed to other governments, or bilateral debt. With HIPC, officials finally recognized that they would have to reduce the debt owed to the World Bank, the IMF, and the regional development banks.

Eligibility for the HIPC initiative was limited to the world's poorest countries. Moreover, in its initial design, the program was not intended to eliminate all foreign debt in these countries, but to reduce this debt to sustainable levels (Van Trotsenberg and MacArthur 1999). The IMF and the World Bank estimated that the typical country that completed the program would see its debt reduced by two-thirds and its debt-service ratio cut in half. Like other IMF and World Bank programs, the HIPC initiative incorporated conditionality. The initiative was

structured around a two-stage process. In stage one, governments worked with domestic groups, the IMF, and the World Bank to develop Poverty Reduction Strategy Papers (PRSP). The PRSP described the macroeconomic, structural, and social policies the government would adopt in order to foster growth and reduce poverty. The idea was for governments to establish track records of implementing the strategy presented in the PRSP. At the end of the stage, countries would reach the “decision point,” at which time the IMF and the World Bank conducted a debt-sustainability analysis to determine the country’s eligibility for debt forgiveness. In stage two, the government continued to adhere to the PRSP targets until the IFIs were satisfied that it was committed to the program. Once the IMF and the World Bank concluded that the government had satisfactorily implemented its program, the country reached the “completion point” and gained the full amount of debt relief committed at the decision point.

The HIPC initiative was an important step in the management of the debt burden. However, critics charged that HIPC would not fully resolve the debt crisis, and that a full resolution required 100-percent forgiveness (see, for example, Roodman 2001; Birdsall and Williamson 2002). By the fall of 2004 some governments in the advanced industrialized countries were reaching the same conclusion (Blustein 2004b). The Group of Eight (G-8) initially discussed 100-percent forgiveness for the HIPC countries during the IMF–World Bank meetings in October 2004; by early June of 2005, the G-8 finance ministers had officially proposed that the World Bank, the IMF, and the African Development Fund (ADF) forgive all of their claims on the countries in the HIPC process. This first official call for 100-percent cancellation was reaffirmed by the G-8 heads of state 1 month later at the G-8 Summit in Gleneagles, Scotland. Governments announced the final details of this initiative, christened the **Multilateral Debt Relief Initiative** (MDRI), at the IMF World Bank meetings in March 2006. The cost of cancellation, estimated at the time at \$50 billion, was financed through contributions to the multilateral lenders by the advanced industrialized countries.

By 2017, the HIPC initiative and the MDRI had eliminated practically all of the accumulated foreign debt burden for the 36 heavily indebted developing countries that had reached the completion point (World Bank 2017a). In all, the programs relieved these 36 countries of \$101.4 billion of debt, shrinking their combined foreign

debt burden to only \$5 billion at the end of 2015. Consequently, the debt-to-GDP ratios had fallen from 114 percent in 1999 to 22 percent in 2015. Encouragingly, current indicators suggest that now that they are no longer burdened by large foreign debts, governments in these societies are dedicating at least a portion of the resources previously directed to debt service to critical social programs such as health and education.

BRETTON WOODS II

Perhaps the most profound consequence of the Asian crisis concerned not just East Asia but the entire international financial system. Arguably the roots of the 2008–2009 global financial crisis lie in East Asian governments' responses to the 1997 crisis. East Asian governments drew one overarching lesson from the crisis and crisis management: don't allow the economy to become vulnerable to shifts in market sentiment or subject to IMF intervention. As we have seen, crises induced by capital flows were politically destabilizing; IMF conditions reflected American interests and, as a consequence, carried deeply intrusive and often inappropriate policy demands. Thus, the central lesson governments drew from the crisis was, "never again."

East Asian governments relied on two mechanisms to reduce the likelihood that they faced future crises that pushed them to the IMF. The first line of defense was self-insurance through the accumulation of large stocks of foreign exchange reserves. Starting from less than zero in the crisis countries, and not substantially above zero in other countries, East Asian governments as a group accumulated more than \$4 trillion in foreign exchange reserves between 1998 and the end of 2009. This amount constituted slightly more than half of global reserve holdings (U.S. Department of the Treasury, 2010). China accumulated the largest stock of foreign exchange reserves by far, holding about \$2.4 trillion by the end of 2009. Japan, with the second largest stock, held just less than \$1 trillion.

Asian governments accumulated foreign exchange reserves by running persistent and large current account surpluses. Up until the 1997 crisis, most economies ran current account deficits in most years. These deficits were financed by the capital inflows that eventually triggered the crisis. These deficits disappear in 1998, however, and from 1998 until the crisis hit in 2009, East Asian economies ran large current account surpluses. Indeed, as we saw in [Chapter 11](#), East Asian economies emerged as important creditor countries after 2000.

East Asian economies have been able to run persistent current account surpluses in part because they have pegged their currencies to the dollar at competitive (many analysts argue undervalued) exchange rates. The competitive exchange rates encourage exports and discourage imports. Of equal importance, however, has been the dominant tendency to engage in sterilized intervention to maintain these exchange-rate pegs. Under sterilized intervention, a government with a current account surplus will exchange local currency for foreign currency at the fixed rate and then subsequently offset the impact of these purchases on the domestic money supply. Consequently, government foreign exchange reserve holdings increase, but the money supply does not. The currency thus remains competitively valued. In East Asian countries, the government then used the foreign exchange reserves (largely dollars) to purchase U.S. government securities and government-backed securities.

Policy Analysis and Debate

Does China's Creditor Status Confer Political Power?

Question

Does the Chinese government's status as a large lender to the United States government confer creditor power that China can exploit to alter American policy?

Overview

During the last decade, the Chinese government has emerged as the single largest foreign lender to the United States government. China's current account surpluses have generated an increase in the Chinese government's official dollar holdings. Rather than hold these reserves in the form of dollars, which pay no interest rates, China has used them to purchase relatively safe financial instruments that do pay interest. U.S. government debt is the safest instrument available. Hence, China's current account surpluses have transformed China into a major foreign funder of U.S. government debt. At the end of May 2010, China owned \$868 billion worth of U.S. government securities (United States Department of the Treasury, 2010). This constitutes about 6.5 percent of total U.S. debt, but about 22 percent of total foreign-owned U.S. debt. Hence, a substantial share of U.S. government debt is controlled by a single foreign government that is

not closely allied with the United States. Moreover, the ability for the United States to run deficits rests, in part, on the continued willingness of the Chinese government to acquire and hold U.S. government debt.

China's emergence as an important creditor to the U.S. government has raised questions about financial power. Some argue that its creditor status confers upon China substantial power. China's creditor position might make it difficult to defend American interests in Asia. As President Obama remarked during the campaign, "It's pretty hard to have a tough negotiation when the Chinese are our bankers" (cited in Drezner 2009, 15). China might also gain leverage over U.S. policy at home. A threat to dump U.S. debt or to refuse to purchase more could sharply increase the cost of funding the debt. The desire to avoid these costs could encourage the U.S. to change policy in line with China's interests. Other analysts argue that creditor status does not confer much power. They emphasize the interdependent nature of the relationship. China buys U.S. debt so that the United States can buy Chinese goods. Moreover, because China holds so much U.S. debt, a massive sell-off would be quite painful.

Policy Options

- China's status as a major creditor to the U.S. government confers power that China can exploit and that must be a source of concern for the U.S. government.
- China's status as a major creditor results from economic interdependence and thus does not generate exploitable power.

Policy Analysis

- What factors determine whether creditor status confers political power?
- How does China's trade relationship with the United States influence its orientation toward the acquisition of additional U.S. debt?
- What if anything could China do to exploit its status without reducing the value of its assets?

Take A Position

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How

would you defend your recommendation against these criticisms?

Resources

Online: Visit the U.S. Department of the Treasury’s “Treasury International Capital System” to update the data on foreign ownership of U.S. government debt.

www.treasury.gov/tic/fpis.shtml

In Print: Daniel Drezner. 2009. “Bad Debts: Assessing China’s Financial Influence in Great Power Politics.” *International Security*, 34(2): 7–45, and Brad Setser, *Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness* (New York: Council on Foreign Relations, 2008).

The system that results from these arrangements has come to be called “**Bretton Woods II**” (Dooley, Folkerts-Landau and Garber 2004). East Asian governments peg to the dollar because the United States is their most important trade partner. East Asian economies run persistent trade surpluses with the United States (and with the world as a whole). East Asian governments finance exports in excess of imports by using the dollars they earn from their export surplus to purchase and hold U.S. government debt instruments. These arrangements are a modern-day Bretton Woods for two reasons. First, the U.S. trade deficit drives growth in East Asia, just as the U.S. current-account imbalance drove early postwar growth in Europe. Moreover, the system is stable as long as East Asian countries are willing to accumulate claims on the U.S. government, just as the original Bretton Woods system was stable as long as European governments were willing to accumulate claims on U.S. gold.

As a second line of defense, East Asian governments created a regional framework for financial cooperation (see Henning 2002 and Chey 2009). Called the **Chiang Mai Initiative**, this regional body provided framework within which governments could pool their foreign exchange reserves to assist each other in the event of market turbulence. The idea of an Asian mechanism first emerged in the fall of 1997. Wary of American and IMF objectives in the conditionality agreements, Japan proposed an Asian Monetary Fund that would effectively supplant the IMF in the region. The proposal drew strong opposition from the United States, who viewed it as a challenge to American interests in the region, and indifference from many East Asian governments, who were a bit wary of Japanese ambitions in the region. The proposal also failed to attract support from China.

Consequently, the Japanese stepped back from the initiative.

The push for regional financial cooperation re-emerged in late fall 1997. Still fuming at their treatment by the IMF, ASEAN governments invited China, Japan, and South Korea to their summit to explore financial cooperation. By 1998, the ASEAN + 3 finance ministers had begun discussion about creating a system of bilateral swap arrangements to provide liquidity to governments facing balance-of-payments problems. In May of 2000, while meeting in Chiang Mai, Thailand, the governments announced that they had reached agreement on the basic framework. Through the CMI, governments pledge to make available a total of \$120 billion. China and Japan are the two largest contributors, each contributing \$38 billion. South Korea contributes approximately \$19 billion, and the balance of contributions comes from governments in the ten smaller ASEAN countries. Each participant in the Initiative would be entitled to swap its currency for U.S. dollars in the amount equal to its contribution times its “purchasing multiplier.”

Bretton Woods II arguably played a key role in the development of the global financial crisis of 2008–2009. The global savings glut, the favored term of many U.S. policymakers, is another name for the huge stock of foreign exchange reserves East Asian governments accumulated. East Asian societies saved as much as 50 percent of their income after 1997, and used an important share of these funds to purchase U.S. government securities. The plentiful demand for U.S. government debt instruments drove down interest rates, and this cheap credit arguably sparked the asset bubbles that popped in 2007 and 2008. Somewhat ironically, therefore, policies that East Asian governments adopted to reduce the likelihood that they would experience another crisis at home contributed to the development of an even larger crisis abroad.

CURRENCY WARS, TAPER TANTRUMS, AND THE GLOBAL CAPITAL FLOW CYCLE

For the developing world as a whole, though, the early 2000s were a period of financial stability. Because investors focused their attention on the American property market capital flows to emerging markets remained relatively low. Moreover, governments in developing countries took advantage of the period to stabilize their economies and accumulate reserves. By 2008, the financial situation in the developing world had improved greatly. Outstanding IMF credit had fallen to less than \$10 billion, the lowest level in almost 30 years, an indication that developing

countries had not only avoided new crises after 2000 but also that they had repaid the loans they had acquired in the late 1990s.

This decade of financial stability in the emerging markets was brought to a close by U.S. policy as the Federal Reserve sought to induce economic recovery in the wake of the global financial crisis. The first political manifestation of the emerging financial volatility came in the fall of 2010 when Brazilian Finance Minister Guido Mantega accused the United States—and the Federal Reserve specifically—of sparking an international currency war. Mantega’s allegation came in midst of a series of rather complex reactions of capital markets and currency markets to America’s monetary policy as the Federal Reserve transitioned from restoring financial stability to fostering post-crisis economic recovery. As an attempt to promote economic activity, the Federal Reserve implemented a second round of quantitative easing, known as QE2, in November 2010. Under QE2, the Fed announced that it would purchase \$600 billion worth of U.S. Treasury securities by the middle of 2011. Such purchases would keep U.S. interest rates low. Low interest rates would encourage private investment that would in turn boost economic output and employment. The Fed extended its policy of quantitative easing in 2012 (which became QE3), as it committed to purchasing \$40 billion worth of Treasury securities every month.

The Fed’s expansionary monetary policy had unintended consequences (spillovers) for the global economy in general and for emerging market economies in particular. Most fundamentally, low interest rates in the U.S. economy encouraged investors to search for higher returns in other countries. Investors thus sold dollar-denominated assets and purchased financial assets in Asian and Latin American economies that had been relatively unaffected by the 2008 financial crisis. As a result, financial capital poured out of dollar-denominated assets and into emerging market assets, causing the dollar to depreciate rather sharply between May 2010 and May 2011. Policymakers in some countries, including in Japan and China, appeared to be intervening in currency markets in an attempt to devalue their currencies against the sinking dollar in order to retain export competitiveness. As a consequence, other emerging market economies with fixed exchange rates were losing export competitiveness and facing strong pressure from domestic industry to devalue. The Brazilian Real was especially hard hit as foreign capital flowed into the Brazilian economy. By late 2010, Goldman Sachs proclaimed the Brazilian currency the world’s most overvalued currency (Reuters 2010). It was in this context that Mantega accused the Federal Reserve of triggering an international

currency war.

The large influx of foreign capital triggered by the Fed's QE2 had consequences for emerging market countries that stretched beyond currency values. Easy access to credit triggered investment booms in many emerging market countries, while overvalued currencies encouraged this investment to flow into nontraded activities such as real estate and construction. As a result, asset prices began to rise rapidly in emerging market countries from 2011, generating fears of an emerging market housing bubble. Governments in many emerging market economies responded to these developments by introducing capital controls in an attempt to divert the inflow. Moreover, and perhaps somewhat surprisingly, this return to capital controls was supported by the International Monetary Fund as it moved toward a new "Institutional View" on capital flows that recognized the potential utility of capital controls in the face of large and possibly destabilizing cross-border flows (see IMF 2011). By late 2012, markets had stabilized.

Stability was short lived however, as the tempers of many emerging market policymakers flared again as the Federal Reserve began to shift away from quantitative easing in the middle of 2013. In May 2013, in the context of his semi-annual testimony to Congress' Joint Economic Committee, Federal Reserve Board Chairman Ben Bernanke suggested that the Fed might begin to reduce the amount of these purchases—Fed purchases of Treasury Securities would taper off—sometime in the near future. Such a shift in Fed policy would cause interest rates to rise in the U.S. In early 2014, the Federal Reserve began to taper.

The shift in American monetary policy hit emerging market economies very hard. Investors that had only months previously been too eager to acquire assets in emerging market economies now rushed to liquidate their assets as fast as they could. Equity markets slumped, governments' foreign exchange reserves eroded, and currencies depreciated. Moreover, the suddenness of the shift in investor sentiment was dramatic—practically overnight. The destabilizing consequences for emerging market economies that resulted from the Federal Reserve's policy shift generated substantial and often very outspoken anger (which was rather patronizingly termed a "taper tantrum") among policymakers in emerging market countries. Raghuram Rajan, who at the time was the Governor of the Reserve Bank of India, was among the most vocal critics of American policy. He accused the Fed of refusing to take into account the impact its policy shift had on the rest of the world. In a speech delivered at the Brookings Institution in Washington, DC, Rajan asked rhetorically, "If the policy hurts the rest of

the world more than it helps the United States, should this policy be pursued” (Caruso-Cabrera 2014). Rajan’s critical perspective was not welcomed by the engineer of the Fed policies, Ben Bernanke, who was in attendance (though no longer the Chairman of the Federal Reserve Board) and challenged Rajan’s claim during the question and answer session that followed Rajan’s speech.

Rajan’s concerns were hardly unique. Indeed, by early 2014 global policymakers, investment banks, and media outlets were becoming increasingly concerned about the financial health of five emerging market economies—India, Brazil, Turkey, South Africa, and Indonesia. Foreign capital had driven an economic boom in each of these economies and as a consequence continued growth had become highly exposed to changes in market sentiment. Of particular concern was the possibility of a sudden change in market sentiment that would trigger a large sell-off, a run on central bank foreign exchange reserves, and a systemic banking crisis. In this case, however, governments moved proactively in an attempt to stem the sell-off. In January, the Turkish central bank responded to market speculation against the Turkish lira by increasing interest rates by 4.25 percentage points—a massive one-time rise. South Africa’s central bank pushed its main rate up the next day, though by a much smaller amount. India had also pushed up its lending rate to reassure nervous investors. To this point, however, the tapers have generated substantial volatility, considerable uncertainty, but have not precipitated a major banking or currency crisis.

This episode highlighted once again two enduring characteristics of the global financial system. First, the system is characterized by a recurring two-phase global cycle in which capital flows between the center of the system in one phase and then to the emerging markets in the other phase. Second, the transition between phases is triggered by changes in U.S. monetary and fiscal policy. And though the specific details of this most recent capital flow cycle are unique, in broad outline the same systemic dynamic generated the Latin American debt crisis and the Asian crisis that we explored earlier in this chapter. The most distinctive aspect of this most recent manifestation of the capital flow cycle is that neither systemic banking nor sovereign debt crises have materialized. Perhaps this indicates that the lessons that governments in the emerging market economies drew from the Asian crisis helped their financial systems withstand the most recent period of volatility. Nevertheless, moving forward, we again confront the realization that reducing the amplitude of the capital flow cycle will require closer macroeconomic cooperation than we have

observed during the last 30 years.

CONCLUSION

At the beginning of the twenty-first century, developing countries are facing new challenges in managing their relationship with the international financial system. On the one hand, international financial integration over the last 20 years has greatly expanded developing countries' opportunities for attracting foreign capital. Yet, those countries seem incapable of escaping from a repeating cycle of overborrowing, crisis, and adjustment that lies at the center of their difficulties. As we have seen, this cycle typically starts with changes in international capital markets. Petrodollars increased the supply of foreign capital to many developing countries during the 1970s, and the dynamics of international financial integration increased the supply of foreign capital to Asian countries during the 1990s. Developing countries have exploited the opportunities presented by changes in international financial markets with great enthusiasm. By reducing the constraints imposed by limited savings and limited foreign exchange, foreign capital allows developing countries to invest more than they could if they were forced to rely solely on domestic resources. The problem, however, is that developing countries eventually accumulate large foreign currency exposures that they cannot service and are pushed to the brink of default. Impending default causes foreign lenders to refuse additional loans to developing countries and to recall the loans they had made previously. Now shut out of international capital markets, developing countries experience severe economic crises and implement stabilization and structural adjustment packages under the supervision of the IMF and the World Bank. This cycle has repeated three times in the last 40 years, once in Latin America during the 1970s and 1980s, once in Asia during the 1990s, and most recently across a geographically diverse set of emerging market economies.

These cycles are driven by the interaction between developments in the international system and those within developing countries. The cycle is driven in part by interests and institutions in the international system over which developing-country governments have little control. The volume and composition of capital flows from the advanced industrialized countries and the developing world have been shaped in large part by changes in international financial markets and changes in American monetary policy. The build-up of debt in Latin America during the 1970s was made possible by the growth of the Euromarkets and the large

deposits in these markets made by OPEC members. The buildup of large foreign liabilities by many Asian countries resulted in part from the more general increase in international financial integration during the late 1980s. The ability to service foreign debt is also influenced by international developments. In the Latin American debt crisis, rising American interest rates and falling economic growth in the advanced industrialized world made it more difficult for Latin American governments to service their foreign debt. In the Asian crisis, the dollar's appreciation against the yen made it more difficult for Asian borrowers to service their debt. Finally, the advanced industrialized countries, the IMF, and the World Bank have established the conditions under which developing countries experiencing crises can regain access to foreign capital.

Interests and institutions within developing countries have also played an important role. Domestic politics influence how much foreign debt is accumulated and the uses to which it is put. In the 1970s, Latin American governments made poor decisions about how to use the foreign debt they were accumulating, thereby worsening their situation when the international environment soured. In Asia, governments failed to regulate the terms under which domestic banks intermediated between foreign and domestic financial markets, thereby weakening domestic financial systems and sparking an erosion of investor confidence in Asia. A country's ability to return to international capital markets following a crisis is contingent on policy reform. Domestic politics often prevents governments from speedily implementing such reforms. Thus, even though it might be tempting to place the blame for the cycle solely on the international financial system or solely on developing-country governments, a more reasonable approach is to recognize that these cycles are driven by the interaction between international and domestic developments.

KEY TERMS

Bretton Woods II
Capital Flow Cycle
Chiang Mai Initiative
Heavily Indebted Poor Countries (HIPC)
Hot Money
Moral Hazard
Multilateral Debt Relief Initiative

SUGGESTIONS FOR FURTHER READING

On the Asian financial crisis, see Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, DC: Institute for International Economics, 2000).

For a broader examination of emerging market strategies in the global financial system, see the contributions in Leslie Elliott Armijo and Saori N Katada, eds., *The Financial Statecraft of Emerging Powers: Shield and Sword in Asia and Latin America*. (London: Palgrave Macmillan, 2014).

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