Barry Eichengreen and Albert Fishlow, "Contending with Capital Flows: What Is Different about the 1990s?", Chapter 2 of *Capital Flows and Financial Crises*, Miles Kahler, ed. 23-64

MAIN SUMMARY

The differences in the main financial institutions and arrangements of the three periods of major portfolio investment—1920s, 1970s and 1990s—conditioned the responses of lending and borrowing governments, of multilateral organizations and of market participants to debt crises. In the 20th century, three periods existed in which major international portfolio investment took place—1924-1929, 1976-1981 and 1990s to now. *While all three periods had trade credits, fixed-interest securities and direct foreign investment (DFI), each period had a characteristic financial market institutions and arrangements mediating the financial flows.* In the 1920s, it was the U.S. bond market. In the latter part of the 1960s commercial banks entered the market and continued through the 1970s. Following the debt crisis of the 1980s, banks withdrew from lending to governments of developing countries, and the new conduit for capital transfer was equity markets. In addition, three more differences existed among the three periods: 1) the scope of the crisis (global, selective and regional, respectively) 2) different levels of intervention by creditor governments and multilateral institutions 3) response of the borrowing countries (import substitution, fiscal adjustment and monetary adjustment, respectively).

THE ERA OF BOND FINANCE

The U.S. switched from being a debtor to a creditor. The U.S. began selling bonds on behalf of other Allied governments and also selling U.S. bonds (e.g. Liberty Loans), which increased the number of bond buyers. Investment trusts were established to pool subscribers' funds to be managed by specialists and commercial banks established bond departments. Such indirect management of investment was subject to agency problems, in which investors did not have full information on the risk of investing abroad. Nevertheless, once the infrastructure of bond departments were established, these institutions pressed the underwriters to make additional bonds available for placement. Thus, when foreign governments sought access to the New York market, they found a ready reception. The development of new markets in countries in fragile political positions was integral to the lending process. In addition, the decline in the U.S. interest rate after 1923 contributed to capital flow abroad. In 1928, the Federal Reserve Board raised the interest rates in a series of steps, reducing investment abroad. New lending abroad dried up in the second half of the year and their entire bill came due. Moreover, the relative price of nonfood primary commodities had also been declining, and the terms of trade of the heavy defaulters (especially Latin American countries) deteriorated dramatically in 1929-1930. The increasing protectionism started in the U.S. compounded these difficulties. As the defaulters could not finance their deficit by running down their reserves anymore, they began imposing various types of capital control. Import substitution was the natural response in the face of the collapse of commodity prices and protectionism in the industrial world. Readjustment of defaulted debts were complicated because of the existence of a large number of investors. The problem was managed by the intervention of bondholders' representative committees, which lacked the reputation and authority to negotiate effectively. And this process proceeded with minimum government intervention Attempts to coordinate the intervention of national governments through institutional institutions emerged, such as proposal to endow the Bank for International Settlements (BIS) with resources to extend credit to debtor countries. At the 1933 World Economic conference, the British proposed the creation of a multilateral "normalization fund" to channel funds to debtor countries seeking to reorganize defaulted debts. While the fear of collapse of the banking system prompted a variety of unprecedented actions, extraordinary assistance for sovereign debtors did not come about.

THE ERA OF BANK FINANCE

The debt crisis of the 1980s was more regionally focused. Substantial private capital inflows first became available to developing countries at the end of the 1960s. As the Eurodollar market sought new borrowers, they found them primarily in Latin America. An improvement in the regionwide growth performance came to an end by the oil price rise in 1973. Latin American governments, unlike Asian governments, were willing to take on debt to sustain imports. Because the real interest was so low, debt appeared to a good strategy, and countries took advantage of borrowing. While expanding debt inhibited growth, it also prevented devaluation because of the implications for increased service payments on outstanding debt. Combining vast financial inflows with limited trade penetration (and increasing deficits and nationalization), Latin American countries in the period after the first oil shock sustained growth, which reinforced military rule. These countries, especially the Southern Cone and the oil exporters, paid the consequences when rising real rates and recessions in industrialized countries came about after the second oil shock. The adjustment consisted of four stages: 1) dramatic BOP correction between 1981 and 1984 2) Banks were not willing to lend more but committed to reducing their exposure to the region 3) The failure of the tripartite (banks, international institutions, and country adjustment) Baker Plan in 1985 and the Brady Plan, which for the first time substantially reduced country indebtedness to banks and 4) Beginning 1991 a sudden and unanticipated flow of capital moved into the region. Three areas of domestic economy restructuring: 1) shift in governmental fiscal capability and a decline in inflation rates 2) change of ownership from public to private 3) reduction of tariffs and quotas. For the first time in the post-World War II period the region has made a commitment to fiscal soundness. These changes are due to the brute force of the adjustment forced on the region. "No longer do people have faith in the ability of state managers to plan."

THE ERA OF EQUITY FINANCE

Two factors increasing equity finance: regulatory changes prompting international diversification of investment portfolios by pension funds and life insurance companies; liberalization of financial markets and growth of mutual funds. In addition, the declining U.S. interest rates helped capital to flow abroad even more. Portfolio equity flows are more likely to be sensitive to changes in international interest rates and therefore subject to sudden reversal. The surge of lending was reduced in the second half of 1994, due

to the increasing U.S. interest rate and a series of unsettling events in Mexico. Because it was an election year, the government prevented the difficult adjustment that would have followed from devaluation of the peso (resulting from the assassination of PRI candidate Colosio) by using the international reserves. The situation was made worse by Mexican nationals' speculation in anticipation of a devaluation just prior to the devaluation in mid-December. The crisis was limited geographically because the overall fundamentals were good. Government budgets were in balance, and savings rates were respectable. Deregulation and privatization have increased the responsiveness of exports. Therefore, the Mexican crisis could be seen as the consequence of an unfortunate conjuncture of economic and political circumstances unique to Mexico (political cycle + recent liberalization of consumer goods imports) rather than a reflection of inconsistent policies in emerging markets generally. Arguments against Mexican rescue: 1) U.S. prosperity does not, generally or specifically, hinge on the Mexican market (ignoring political reaction in Mexico, potential for growth in U.S.-Mexico trade and investment). 2) U.S. bailout can be interpreted as an extension of insurance from the U.S. Treasury (moral hazard). Arguments for the bailout: 1) Controlling contagion to other countries. 2) Since multiple equilibria exist, the market's overreaction to the Mexican devaluation would have unnecessarily aggravated the crisis. / The limited scope of the Thai crisis reflected the benign interest rate environment and the backdrop of global, buoyant economic growth. Thailand had a high private savings rate and a rapid growth rate leading up to the crisis. The crux of the problem was the weakness of the banking system which created uncertainties for foreign investors. Some parallels with the Mexican crisis: 1) absence of the traditional causes of BOP crises (government budget balanced or in surplus; inflation moderate or slight; monetary growth moderate or slight). 2) Current account deficit (private investment > private savings, foreign financing filling the gap) → current account deficits are not a problem if they reflect private-sector rather than public-sector decisions. ER peg and the belief that banks could not be allowed to fail maintained the persistent capital inflow. 3) Both crises cast doubt on the notion that crises erupt in response to wholly unanticipated events; there were plenty of signs for both (expert commentators, speculative pressures). Thailand's mistakes: 1) it clung to a policy of pegging its ER within a narrow band. 2) Management of the financial system (e.g. Thai banks were not required to disclose their non-performing loans); banking crisis interacted with the flaws in the ER management.

POLICY IMPLICATIONS

International capital markets can turn on a dime. They are sensitive to global economic conditions and industrial country interest rates. In this setting bilateral solutions are not feasible. Even IMF conditionalities are politicized, so bilateral ones are even more so. Timeliness and transparency of information would help, but since information is a public good, incentives for provision are inadequate. Whether the IMF is in a better position than the market to recognize signs of impending danger is questionable. Governments can buy insurance against reversals of capital movements by tightening fiscal policies and reforming public pension. But pension reform is contentious and protracted. The other way is to use taxes and taxlike devices, placed on the ability of banks to borrow offshore, to regulate flows. Examples of Chile and Columbia and their imposition of similar barriers confirm the feasibility of measures to stem capital inflows. The idea of a international bankruptcy court would encounter difficulties because the court would not possess the power to seize collateral, nor to "replace" the government of a country as a domestic bankruptcy court would. ***International capital flows have much to recommend them. But in a world of distortions, there is an argument for marginal interventions to limit their magnitude.***