NYU 上海 SHANGHAI 纽约大学

International Political Economy (SOCS-SHU 222)

DEVELOPING COUNTRIES AND INTERNATIONAL FINANCE II: THE GLOBAL CAPITAL FLOW CYCLE

Instructor: JING QIAN

WE ARE ALMOST THERE!

Course Schedule Update

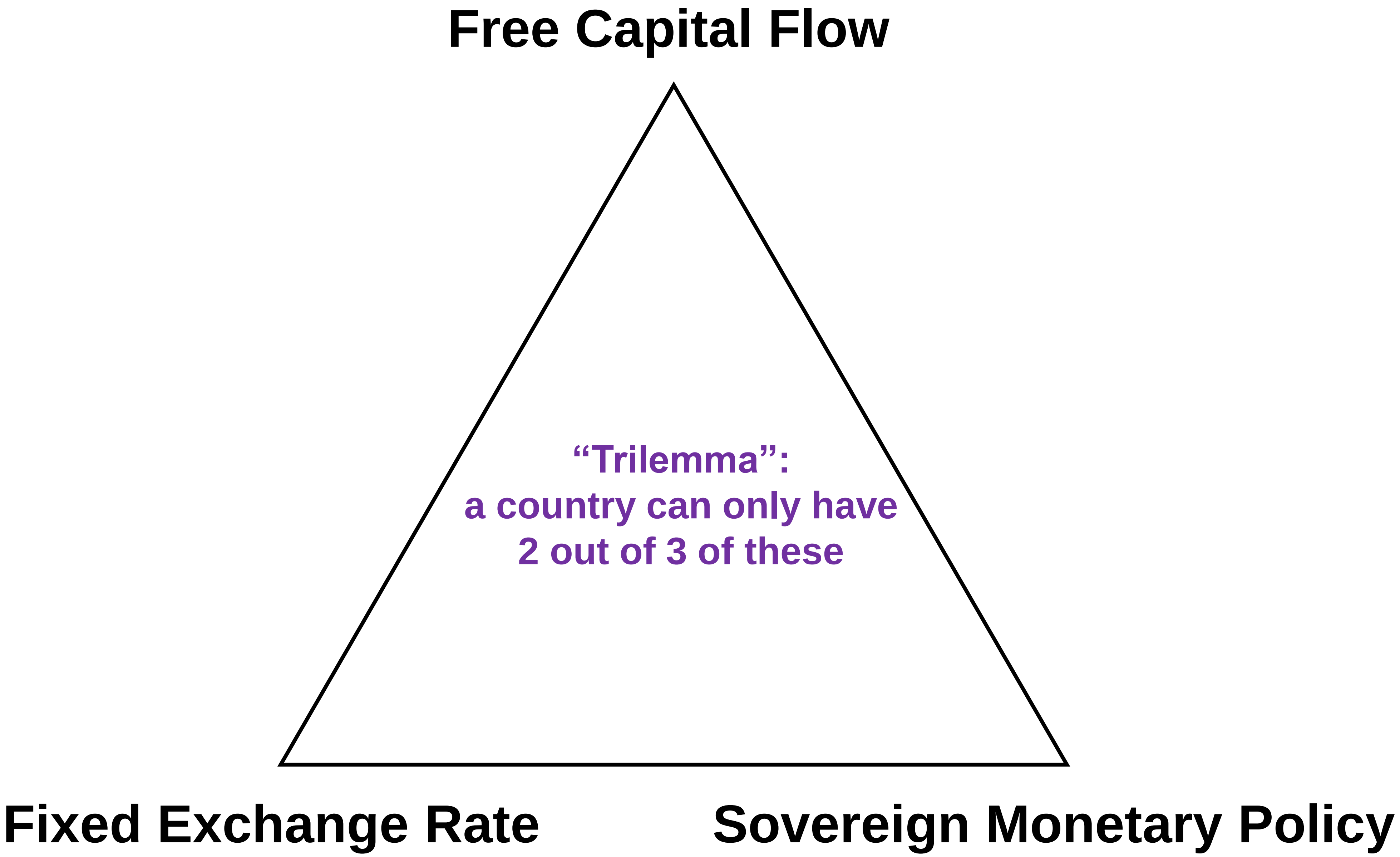
- Tuesday, May 6 The European Monetary Union
- Thursday, May 8 How to Do a Presentation
- Tuesday, May 13 Quiz 2 Review & Concluding Remarks
- Thursday, May 15 NO CLASS
    - Additional Office Hour: 9:30 – 11:30 am & 1:00 – 3:00 pm (over Zoom)
    - Quiz 2 Available: May 16 at 12:00 am – May 18 at 11:59pm

Developing Countries and International Finance II:

The Global Capital Flow Cycle

READING ASSIGNMENT:

Oatley Chapter 15


Free Capital Flow
“Trilemma”:
a country can only have
2 out of 3 of these
Fixed Exchange Rate
Sovereign Monetary Policy

The Global Capital Flow Cycle

BOOM

- Surge in foreign capital inflows
- Low global interest rates & high risk appetite
- Credit expansion & currency appreciation
- Rising asset prices and consumption
- Growing external debt exposure

BUST

- Global tightening (e.g., U.S. rate hikes)
- Capital outflows & currency depreciation
- Falling asset values, debt harder to service
- Sudden stop → financial instability
- Need for adjustment, IMF, controls

The Asian Financial Crisis

The Capital Flow Boom

- 1990s: East Asian economies became major recipients of capital
- Capital inflows fueled by:
  - Financial liberalization in developing countries.
  - Low interest rates in advanced economies.
  - Investor confidence in East Asian “economic miracles.”
- Dominated by “hot money” with high volatility
  - Short-term loans, bonds and stocks, etc.

Financial Liberalization in Asia (Early 1990s)

- Key countries: Thailand, Indonesia, South Korea, Malaysia
- Rapid liberalization of financial markets
- Domestic banks and firms gained easier access to international capital
- Rise of financial intermediation by local banks
  - Borrowed cheaply from international lenders
  - Lent at higher rates to domestic borrowers

Financial Mediation – The Risks

- **Currency Mismatch**
  - Borrowed in USD
  - Lent in local currencies
  - Devaluation → Foreign debt burden surges
- **Maturity Mismatch**
  - Short-term borrowing
  - Long-term lending
  - Lose of investor confidence → Inability to roll over debt

Moral Hazard

- Bailout expectations → Excessive risk-taking by banks
  - Little incentive to screen loans carefully
  - Increases system-wide vulnerability
- Political connections undermined market discipline
  - State-owned banks
  - Institutions controlled by allies of President Suharto (Indonesia)
  - Repeat bailouts (e.g., Bangkok Bank of Commerce, Bank Duta)
- Weak regulation & enforcement
  - Rules existed, but often not enforced
  - Regulators removed or pressured (e.g., Indonesia's central bank governor)

Crisis Breakout

- Yen appreciation → harder for Asian exporters to sell to Japan
  - → Debt-service burden rise
- Real-estate bubble bursts
  - Domestic borrowers struggle to repay loans
  - Domestic banks struggle to repay foreign creditors
- May 1997: Collapse of Thai firm *Finance One* triggers investor panic
- Foreign banks refuse to renew loans, triggering capital flight.
- July 1997: Thailand floats the baht after reserve depletion.
- Panic spreads → capital exits across Asia.

Floating Currencies

- Fixed exchange rates became unsustainable
  - Investor panic → mounting pressure on currency pegs
- Reserves drained defending pegs
  - Central banks sold USD to defend currency → reserves depleted
- Dollar-denominated debt became harder to repay
  - Pegs worsened debt burden as domestic currencies weakened
- Floating restored policy control
  - Allowed interest rate cuts and ended reserve drain
- Floating XR: Thailand, Philippines, Indonesia, Malaysia, Taiwan, etc.

IMF Response to the Crisis

- IMF Bailout packages
  - Philippines ($1.1 billion); Thailand ($16 billion); Indonesia ($23 billion); South Korea ($57 billion)
- Conditionality (Structural Adjustment)
  - Macroeconomic stabilization
    - Tight monetary and fiscal policy to curb inflation
  - Financial sector reform
    - Close insolvent banks and improve regulation
  - Structural reform
    - Liberalize trade and investment, reduce state intervention

IMF Response: The Fallout

- Consequences of IMF packages
  - Sharp economic contractions across Asia
  - Rising unemployment and poverty
  - Political instability
    - Suharto resigns in Indonesia
    - Mass protests in Thailand
  - “NEVER AGAIN”

Images from ***South Korea*** during the East Asian Financial Crisis

Why Reform is Politically Difficult

- Economic reform often requires short-term pain for long-term gain
  - Reforms often benefit future governments, but impose costs on current leaders
  - Politicians have electoral incentives to delay or dilute reforms
- Creates clear, immediate **losers** and diffuse, uncertain **winners**
  - Public employees get laid off
  - Protected industries face competition
  - Middle-class no longer receives subsidies

Who Can Push Reform Through?

Key conditions:

- Strong executive leadership
- Unified government with few veto players

Authoritarian advantage?

- Time horizons & no electoral incentives?
- China's SOE reform in the 1990s: massive layoffs, but no electoral backlash

Democracies need:

- Coalition-building
- Targeted compensation

Thank You!

NYU 上海 SHANGHAI 纽约大学

Take-away

- Boom and bust in the global capital flow cycle
- Financial mediation and mismatch
- Moral hazard
- Asian Financial Crisis
- Self-insurance
- Bretton woods II
- Quantitative Easing (QE)
- Taper tantrum