

Curbing the Boom-Bust Cycle: Stabilizing Capital Flows to Emerging Markets

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International investors poured vast sums of money into East Asia and Latin America during the mid-1990s, when the emerging-market boom was at its peak. Then Thailand stumbled, panic seized the markets, and boom gave way to bust. Investors suffered large financial losses. Asian countries suddenly experienced large capital outflows, and the subsequent macroeconomic pressures plunged into crisis countries that had been growing rapidly. Much the same had happened in Latin America when the debt crisis broke in 1982: The banks that had lent money to the region suffered years of anxiety capped off by substantial losses, and the countries that had been growing nicely suddenly found themselves confronting a lost decade. Latin America again suffered a similar fate a few months after East Asia stumbled, in 1998.

Can feasible policy actions curb the sequence of boom and bust and thus permit both investors and emerging markets to tap the potential benefits of capital mobility without the costs of crises? John Williamson concludes that a significant reduction in the wild swings in capital flows is feasible, even though complete stability is not. The problem of cyclicity cannot be tackled just from the supply side but will require actions on the part of both creditors and debtors. The action program he develops in this study is intended to facilitate progress toward financial maturity in emerging markets similar to that which has already occurred in the industrial countries. A number of the key elements of the action program are described below.

Emerging markets should limit, and perhaps ultimately eliminate, foreign-currency borrowing by their governments. These governments should instead issue inflation-indexed, plain-vanilla bonds on their local markets and growth-linked bonds on the international market. A growth-linked bond pays an interest rate that varies with the growth rate of the domestic economy. For example, a country with a normal average growth rate of 4 percent a year and an ability to borrow at 7 percent could issue a bond that promised to pay 7 percent, plus or minus the differential of realized growth over 4 percent (plus a premium if that were needed to persuade investors to buy such bonds). The country would pay more when growth was strong and when it was in a position to pay more and would pay less when times were difficult.

Emerging-market governments should also discourage their private-sector borrowers and lenders from issuing and holding assets denominated in foreign currency since currency mismatches in debtor countries aggravate crises. This might be accomplished by imposing higher taxes on interest earned on foreign-currency assets than on interest from domestic currency-denominated assets or by limiting the tax concessions on interest on borrowing that is denominated in foreign rather than domestic currency.

Multilateral development banks (MDBs) should design their lending policies to eliminate currency mismatches in emerging markets' borrowing from the MDBs. These banks should borrow in a synthetic currency unit whose value is defined by a basket of emerging-market currencies indexed to the countries' own price levels. They could then largely avoid currency exposure by lending to emerging markets in their own currencies, on an indexed basis, in roughly the same proportions in which the basket is composed.

Commercial banks in creditor (as well as debtor) countries should switch to forward-looking provisioning rules. Under this system, a bank making a loan adopts provisions based on past historical experience of loan defaults when a loan is first made, rather than waiting for evidence that the particular borrower or individual loan is in difficulty before any provision is made. This avoids pressure to cut back lending, and thus aggravate recession, at times of difficulty.

Emerging markets ought to retain the right to use capital controls in certain situations, especially where they are being flooded with excessive capital inflows. Normally such controls should take the form of (a) imposition of uncompensated reserve requirements; (b) taxation of capital flows; or (c) creation of a parallel foreign exchange market through which pension funds and mutual funds would be obliged to channel their transactions.

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