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Introduction

International investors poured vast sums of money into East Asian and Latin American countries 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 macroeconomic pressures these wrought plunged countries that had been growing rapidly ("miraculously") into crisis. 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. If one goes back in history, one finds that these are only the most recent of a succession of booms in lending to emerging markets that have given way to busts that impoverished both those who lent money and those who borrowed from them (Eichengreen and Lindert 1989).

That is not how the textbooks explain the consequences of capital mobility. The textbook picture is rather one of mutual gain, in which resources are shifted from areas of excess savings to areas with a surfeit of profitable investment opportunities or in which both parties benefit from portfolio diversification without any actual flow of real capital necessarily occurring. One can indeed think of cases where these gains were realized in practice: Canada's rapid development in the late 19th century with foreign capital, Norway's development of its oil industry in the 1970s, Singapore's success in growing by attracting multinationals, and Korea's heavy borrowing in the 1960s and 1970s.

Nevertheless, the outcome has all too often not been so benign. As Borensztein and Mauro (2004) recently summarized the historical survey in Bordo et al. (2001):

> External financing crises are far from being a novel feature of the international financial system: they have recurred at various times during the past two centuries, typically following periods of large financial flows . . . toward the emerging markets of the day.

The issue that is addressed in this study is whether it has to be this way or whether feasible policy actions could 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 the crises that have so often ensued. That question is of particular importance at this time because many emerging markets seem to have reacted to the crises of the 1990s by ceasing to borrow, just at a time when demographics suggest that there is particular scope for gain by channeling Northern savings into investments in the South.

This study starts by analyzing the nature of the boom-bust cycle, first by looking at the general case and then by taking the East Asian case as an example of where lending went too far. It is argued that capital flows can be, and indeed frequently are, excessive. On the one hand, investors often act in herds and thus pour in foreign funds to a level that makes a crisis likely. On the other hand, borrowers have difficulty resisting the temptation to take all that is offered in the good times, are typically guilty of hubris ("this time it is different because . . ."), and end up taking too much. Crises are costly. In principle, one solution would be to cut the Gordian knot and end capital mobility (if one could), but that not only might be infeasible but (as analyzed in chapter 2) also would mean forgoing a series of real potential advantages that capital movements could bring.

A less drastic approach is to examine whether actions could be taken by creditors and debtors that might stabilize the flow of capital at a level that would make economic sense. As a prelude to this, chapter 4 examines the different forms of capital inflow, with a view to deciding which forms one might wish to promote at the expense of others as well as which forms are in particular need of action to reduce volatility. Chapter 5 contains a description of the asset management industry, that is, the institutional arrangements that govern many of those capital flows.

The two principal chapters of the book, chapters 6 and 7, are dedicated to examining the possibilities of action to reduce the volatility of capital flows on the part of the creditors and the debtors, respectively. So far as the creditors are concerned, the study identifies a series of relatively minor actions that could be helpful, but, unless—improbably—investors were to abandon their current focus on maximizing yields in each short-run period, the study concludes that capital flows would probably not be profoundly affected. Debtors could do more on their own account, but some

of the actions that would seem most likely to be effective would require the agreement of the general international community, including the source countries, to change the international rules of the game. That is why cooperative international action will be necessary to achieve a significantly more stable flow of capital, with all the benefits that might entail.

It is the intention of this study to provide a guide to the set of actions that would seem most likely to further this outcome. No one should imagine that this will involve anything like complete stability in the flow of capital, but a significant diminution in the wild swings that have characterized the past seems both feasible and desirable.