Williams College
Center for Development Economics
Econ 516T(S), Spring 2005, by appointment

DEVELOPING COUNTRIES AND THE INTERNATIONAL CAPITAL MARKETS

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Course description

This course will analyze the pros and cons of international financial liberalization, namely, the opening up to capital inflows and outflows on the part of developing and transition countries.

The specific topics to be covered include the advantages and disadvantages of attracting direct investment versus portfolio flows; the determinants and peculiarities of global capital movements, including "contagion" and "sudden stop" phenomena; the roles of credit rating agencies in facilitating access to international lenders and investors, and of the IMF in preventing and helping to overcome capital account liberalization problems; the importance of currency and maturity mismatches and the effectiveness of controls on capital flows; and the relationship between capital flows, overindebtedness and sovereign debt defaults.

Our readings consist of the latest empirical and policy writings on the various topics – as opposed to theoretical papers or classic works from earlier years – and they are drawn from a variety of authors around the globe that are doing state-of-the-art research. The format is that of tutorial meetings in groups of 2 students, at an hour to be mutually agreed. The requirement is one paper every other week, for a total of 5 papers, to be delivered via e-mail (to Arturo.C.Porzecanski@williams.edu) by Wednesday 5PM before the Friday class during which the paper is to be discussed. The papers should make reference to the required readings but should go beyond a mere summary or critique of said readings, as per the suggestions provided in this syllabus. The prerequisite is Economics 509 and the enrollment limit is 10 students. Undergraduate enrollment is limited and only accepted with permission from the instructor.

Schedule and readings

February 4: Background on financial globalization

Required readings:

1) Barry Eichengreen, "A century of capital flows" and "Capital account liberalization: what do the cross-country studies tell us?," in Barry Eichengreen, Capital Flows and Crises (Cambridge, MA: MIT, 2003), pp. 13-69.

2) James A. Hanson, Patrick Honohan and Giovanni Majnoni, “Globalization and national financial systems: issues of integration and size,” in James A. Hanson et al., editors, Globalization and National Financial Systems (New York: Oxford, 2003), pp. 1-32.

Supplementary reading: Pierre-Richard Agénor, “Benefits and costs of international financial integration: theory and facts,” World Economy, Vol. 26 #8, August 2003, pp. 1089-1118.

February 18: Direct investment vs. portfolio flows, Part 1

Questions you may want to address in your paper: What kind of FDI has arrived in your country, and what benefits and costs has it entailed? What incentives have been provided to FDI investors in your country, if any, and what has been the experience with them? What should be done, in terms of institutional and human capital development, in order to maximize the contribution that FDI can make to your country's development?

Required readings:

1) Robert E. Lipsey, “Home- and host-country effects of foreign direct investment,” in Robert E. Baldwin and L. Alan Winters, editors, Challenges to Globalization: Analyzing the Economics (Chicago: Chicago, 2004), pp. 333-382.
2) Libor Krkoska, “Foreign direct investment financing of capital formation in central and eastern Europe,” EBRD Working Paper #67, December 2001, in www.ebrd.org/pubs/econ/workingp/67.pdf
3) Eduardo Fernández-Arias and Ricardo Hausmann, “Is foreign direct investment a safer form of financing?,” Emerging Markets Review, Vol. 2 #1, March 2001, pp. 34-49.

Supplementary readings:

1) José De Gregorio, “The role of FDI and natural resources in economic development,” draft, May 2004, in www.bcentral.cl/jdegrego/pdf/jdeg-fdi.pdf
2) David L. Carr, James R. Markusen and Keith E. Maskus, “Competition for multinational investment in developing countries: human capital, infrastructure and market size,” in Challenges to Globalization…, op. cit., pp. 383-410.
3) Ashoka Mody, “Is FDI integrating the world economy?,” World Economy, Vol. 27 #8, August 2004, pp. 1195-1222.
4) Nauro F. Campos and Yuko Kinoshita, “Why does FDI go where it goes? New evidence from the transition economies,” IMF Working Paper WP/03/228, November 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03228.pdf
5) Stijn Claessens and Jong-Kun Lee, “Foreign banks in low-income countries: recent developments and impacts,” in Globalization and National…, op. cit., pp. 109-141.
6) Ann E. Harrison, Inessa Love and Margaret S. McMillan, “Global capital flows and financing constraints,” Journal of Development Economics, Vol. 75 #1, October 2004, pp. 269-301.

7) Report of the Working Group of the Capital Markets Consultative Group, IMF, “Foreign direct investment in emerging market countries,” September 2003, in www.imf.org/external/np/cmcg/2003/eng/091803.pdf
8) Theodore H. Moran, Beyond Sweatshops: FDI and Globalization in Developing Countries (Washington, DC: Brookings Institution, 2002).
9) Imad A. Moosa, Foreign Direct Investment: Theory, Evidence and Practice (New York: Palgrave Macmillan, 2002).

February 25: Direct investment vs. portfolio flows, Part 2

Questions you may want to address in your paper: What kind of portfolio flows have arrived in your country, and what benefits and costs have they entailed? How liberal an environment does your country provide for portfolio investors? What should be done, in terms of financial structures and institutional development, in order to maximize the contribution and minimize the risks of portfolio flows to your country’s development?

Required readings:

1) René M. Stulz, “Should we fear capital flows?,” in Leonardo Aurenheimer, editor, International Financial Markets: The Challenge of Globalization (Chicago: Chicago, 2003), pp. 103-146.
2) Peter Blair Henry and Peter Lombard Lorentzen, “Domestic capital market reform and access to global finance: making markets work,” in Robert E. Litan, Michael Pomerleano and V. Sundararajan, editors, The Future of Domestic Capital Markets in Developing Countries (Washington: Brookings, 2003), pp. 179-214.
3) Joost Driessen and Luc Laeven, “The value of international portfolio diversification,” in Globalization and National…, op. cit., pp. 175-188.

Supplementary readings:

1) Abdul Abiad, Nienke Oomes and Kenichi Ueda, “The quality effect: does financial liberalization improve the allocation of capital?,” IMF Working Paper WP/04/112, June 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04112.pdf
2) Irina Tytell and Shang-Jin Wei, “Does financial globalization induce better macroeconomic policies?,” IMF Working Paper WP/04/84, May 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0484.pdf
3) Scott L. Baier, Gerald P. Dwyer Jr. and Robert Tamura, “Does opening a stock exchange increase economic growth?,” Journal of International Money and Finance, Vol. 23 #3, April 2004, pp. 311-331.
4) IMF, “Institutional investors in emerging markets,” IMF Global Financial Stability Report, April 2004, pp. 111-151, in www.imf.org/External/Pubs/FT/GFSR/2004/01/pdf/chp4.pdf
5) Eswar S. Prasad et al., “Effects of financial globalization on developing countries: some empirical evidence,” IMF Occasional Paper #220, 2003.
6) Barry Eichengreen with Carlos Arteta and Charles Wyplosz, “When does capital account liberalization help more than it hurts?,” in Capital Flows and Crises, op. cit., pp. 71-96.

7) Graciela Laura Kaminsky and Sergio L. Schmukler, “Short-run pain, long-run gain: the effects of financial liberalization,” IMF Working Paper WP/03/34, February 2003, in www.imf.org/external/pubs/ft/wp/2003/wp0334.pdf
8) Nicola Fuchs-Schündeln and Norbert Funke, “Stock market liberalizations: financial and macroeconomic implications,” IMF Working Paper WP/01/193, December 2001, in www.imf.org/external/pubs/ft/wp/2001/wp01193.pdf
9) Stijn Claessens, Daniel Oks and Rossana Polastri, “Capital flows to central and eastern Europe and the former Soviet Union,” in Sebastian Edwards, editor, Capital Flows and the Emerging Economies (Chicago: Chicago, 2000), pp. 299-340.

March 4: Contagion and sudden stops, Part 1
Questions you may want to address in your paper: Has your country suffered from contagion effects, and if not, why not? Do you think that your country is vulnerable to contagion effects and, if so, what should be done to reduce that vulnerability?

Required readings:
1) Michael D. Bordo, “The globalization of international financial markets: what can history teach us?” in International Financial Markets…, op. cit., pp. 29-78.
2) Leonardo Hernández, Pamela Mellado and Rodrigo Valdés, “Determinants of private capital flows from the 1970s and 1990s: is there evidence of contagion?,” IMF Working Paper WP/01/64, May 2001, in www.imf.org/external/pubs/ft/wp/2001/wp0164.pdf
3) Graciela Kaminsky, Carmen Reinhart and Carlos Vegh, “The unholy trinity of financial contagion,” Journal of Economic Perspectives, Fall 2003, pp. 51-74.

Supplementary readings:
1) Graciela L. Kaminsky, Carmen M. Reinhart and Carlos A. Végh, “When it rains it pours: procyclical capital flows and macroeconomic policies,” NBER Working Paper #10780, September 2004, in www.nber.org/papers/w10780.pdf
2) Jorge A. Chan-Lau, Donald J. Mathieson and James Y. Yao, “Extreme contagion in equity markets,” IMF Staff Papers, Vol. 51, # 2, August 2004, in www.imf.org/External/Pubs/FT/staffp/2004/02/pdf/chanlau.pdf
3) Gianluigi Ferrucci et al., “Understanding capital flows to emerging market economies,” Bank of England Financial Stability Review, Issue 16, June 2004, in www.bankofengland.co.uk/fsr/fsr16art6.pdf
4) Francesco Caramazza, Luca Ricci and Ranil Salgado, “International financial contagion in currency crises,” Journal of International Money and Finance, Vol. 23 #1, February 2004, pp. 51-70.
5) Thomas Moser, “What is international financial contagion?,” International Finance, Vol. 6 #2, 2003, pp. 157-178.
6) G. Andrew Karolyi, “Does international financial contagion really exist?,” International Finance, Vol. 6 #2, 2003, pp. 179-199.

7) Massimo Sbracia and Andrea Zaghini, “The role of the banking system in the international transmission of shocks,” World Economy, Vol. 26 #5, May 2003, pp. 727-754.
8) José de Gregorio and Rodrigo O. Valdés, “Crisis transmission: evidence from the debt, Tequila, and Asian flu crises,” in Stijn Claessens and Kristin J. Forbes, editors, International Financial Contagion (Boston: Kluwer, 2001), pp. 99-127.
9) Gaston Gelos and Ratna Sahay, “Financial market spillovers: how different are the transition economies?,” in International Financial Contagion, op. cit., pp. 329-366.

March 11: Contagion and sudden stops, Part 2
Questions you may want to address in your paper: Has your country suffered from a “sudden stop” and if not, why not? Do you think that your country is vulnerable to sudden stops and, if so, what should be done to reduce that vulnerability?

Required readings:
1) Guillermo A. Calvo and Carmen M. Reinhart, “When capital inflows suddenly stop: consequences and policy options,” in Peter B. Kenen and Alexander K. Swoboda, editors, Reforming the International Monetary and Financial System (Washington, DC: IMF, 2000), pp.175-201.
2) Pablo E. Guidotti, Federico Sturzenegger and Agustín Villar, “On the consequences of sudden stops,” Economía, Spring 2004, pp. 171-214.
3) Guillermo A. Calvo, Alejandro Izquierdo and Luis-Fernando Mejía, “On the empirics of sudden stops: the relevance of balance-sheet effects,” in IADB Research Dept. Working Paper #509, July 2004, in www.iadb.org/res/publications/pubfiles/pubWP-509.pdf

Supplementary readings:
1) Sebastian Edwards, “Financial openness, sudden stops, and current-account reversals,” American Economic Review, Vol. 94 #2, May 2004, pp. 59-64.
2) Ricardo Caballero, Kevin Cowan and Jonathan Kearns, “Fear of sudden stops: lessons from Australia and Chile,” NBER Working Paper #10519, May 2004, in www.nber.org/papers/w10519.pdf
3) Ilan Goldfajn, “The swings in capital flows and the Brazilian crisis,” in Stephanie Griffith-Jones et al., editors, International Capital Flows in Calm and Turbulent times (Ann Arbor, MI: Univ. of Michigan Press, 2003), pp. 267-290.

April 8: Role of credit rating agencies and the IMF, Part 1
Questions you may want to address in your paper: Does your country have a credit rating and if so, do you think it is a fair assessment? If your country does not yet have a credit rating, do you think it should?

Required readings:

1) Standard & Poor's, "Sovereign credit ratings: a primer," 15 March, 2004.
2) Amadou N. R. Sy, "Rating the rating agencies: anticipating currency crises or debt crises?," Journal of Banking and Finance, Vol. 28 #11, November 2004, pp. 2845-2867.
3) Graciela Kaminsky and Sergio L. Schmukler, "Emerging market instability: do sovereign ratings affect country risk and stock returns?," World Bank Economic Review, Vol. 16, #2, 2002, pp. 171-195.

Supplementary readings:

1) Roman Kräussl, "Do credit rating agencies add to the dynamics of emerging market crises?," Center for Financial Studies Working Paper #2003/18, August 2003, in www.ifk-cfs.de/English/homepages/h-veroeffentlichungen-forschung.htm
2) Robert Brooks et al., "The national market impact of sovereign rating changes," Journal of Banking and Finance, Vol. 28 #1, January 2004, pp. 233-250.
3) Ashok Vir Bhatia, "Sovereign credit ratings methodology: an evaluation," IMF Working Paper WP/02/170, October 2002, in www.imf.org/external/pubs/ft/wp/2002/wp02170.pdf
4) Arturo Estrella et al., "Credit ratings and complementary sources of credit quality information," Basel Committee on Banking Supervision Working Paper #3, August 2000, in www.bis.org/publ/bcbs_wp3.pdf
5) Carmen M. Reinhart, "Default, currency crises, and sovereign credit ratings," World Bank Economic Review, Vol. 16, #2, 2002, pp. 151-170.

April 15: Role of credit rating agencies and the IMF, Part 2

Questions you may want to address in your paper: Does your country depend on the IMF for financing and advice, and if so do you think it should try to graduate? What have been the pros and cons of your country's relationship with the Fund? What are the policy implications of your assessment?

Required readings:

1) Michael Bordo, Ashoka Mody and Nienke Oomes, "Keeping capital flowing: the role of the IMF," in IMF Working Paper WP/04/197, October 2004, in www.imf.org/external/pubs/ft/wp/2004/wp04197.pdf
2) Roberto Benelli, "Do IMF-supported programs boost private capital inflows? The role of program size and policy adjustment," in IMF Working Paper WP/03/231, November 2003, in www.imf.org/external/pubs/ft/wp/2003/wp03231.pdf
3) Claudio Cottarelli and Curzio Giannini, "Bedfellows, hostages, or perfect strangers? Global capital markets and the catalytic effect of IMF crisis lending," in IMF Working Paper WP/02/193, November 2002, in www.imf.org/external/pubs/ft/wp/2002/wp02193.pdf

Supplementary readings:

1) John Cady, "Does SDDS subscription reduce borrowing costs for emerging market economies?," in IMF Working Paper WP/04/58, April 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0458.pdf
2) Atish Ghosh et al., "IMF-supported programs in capital account crises," IMF Occasional Paper #210, 2002.
3) IMF Independent Evaluation Office, The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil (Washington, DC: IMF, 2003), also in www.imf.org/external/np/ieo/2003/cac/pdf/main.pdf
4) Michael M. Hutchison, "A cure worse than the disease? Currency crises and the output costs of IMF-supported stabilization programs," in Michael P. Dooley and Jeffrey A. Frankel, editors, Managing Currency Crises in Emerging Markets (Chicago: Chicago, 2003), pp. 321-359.
5) Takatoshi Ito, "The role of IMF advice: a postcrisis examination," in Reforming the International…, op. cit., pp. 293-344.
6) David Vines and Christopher L. Gilbert, editors, The IMF and its Critics: Reform of Global Financial Architecture (Cambridge: Cambridge, 2004).

April 22: Role of mismatches and capital controls, Part 1

Questions you may want to address in your paper: Are currency and other mismatches prevalent in your country, and if so why or why not? What do you think should be done to minimize these mismatches, or to prevent their negative consequences?

Required reading: Morris Goldstein and Philip Turner, Controlling Currency Mismatches in Emerging Markets (Washington, DC: IIE, 2004), pp.1-120.

Supplementary readings:

1) Barry Eichengreen, Ricardo Hausmann and Ugo Panizza, "Currency mismatches, debt intolerance and original sin: why they are not the same and why it matters," NBER Working Paper #10036, October 2003, in www.nber.org/papers/w10036.pdf
2) Ricardo Hausmann, "Good credit ratios, bad credit ratings: the role of debt structure," in George Kopits, editor, Rules-Based Fiscal Policy in Emerging Markets (New York: Palgrave MacMillan, 2004), pp. 30-52.
3) Adolfo Barajas and R. Armando Morales, "Dollarization of liabilities: beyond the usual suspects," IMF Working Paper WP/03/11, January 2003, in www.imf.org/external/pubs/ft/wp/2003/wp0311.pdf
4) Mark Allen et al., "A balance sheet approach to financial crisis," IMF Working Paper WP/02/210, December 2002, in www.imf.org/external/pubs/ft/wp/2002/wp02210.pdf

April 29: Role of mismatches and capital controls, Part 2

Questions you may want to address in your paper: Does your country impose controls on capital inflows, and if so why or why not? What do you think have been the good *and bad consequences of having (or not having) capital controls? What are the policy implications of your assessment?*

Required readings:

1) Mark Carlson and Leonardo Hernández, "Determinants and repercussions of the composition of capital inflows," Federal Reserve International Finance Discussion Paper #717, January 2002, in www.federalreserve.gov/pubs/ifdp/2002/717/ifdp717.pdf
2) Sebastian Edwards, "Capital flows, real exchange rates, and capital controls: some Latin American experiences," in Capital Flows and the Emerging…, pp. 197-253.
3) Francisco Nadal-De Simone and Piritta Sorsa, "A review of capital account restrictions in Chile in the 1990s," IMF Working Paper WP/99/52, April 1999, in www.imf.org/external/pubs/ft/wp/1999/wp9952.pdf

Supplementary readings:

1) Kristin J. Forbes, "Capital controls: mud in the wheels of market discipline," NBER Working Paper #10284, January 2004, in www.nber.org/papers/w10284.pdf
2) Ethan Kaplan and Dani Rodrik, "Did the Malaysian capital controls work?," in Sebastian Edwards and Jeffrey A. Frankel, editors, Preventing Currency Crises in Emerging Markets (Chicago: Chicago, 2002), pp. 393-440.
3) Rudi Dornbusch, "Malaysia's crisis: was it different?," in Preventing Currency…, op. cit., pp. 441-458.
4) Akira Ariyoshi et al., "Capital controls: country experiences with their use and liberalization," IMF Occasional Paper #190, 2000.
5) José de Gregorio, Sebastian Edwards and Rodrigo O. Valdés, "Controls on capital inflows: do they work?," Journal of Development Economics, Vol. 63 #1, October 20000, pp. 59-83.

May 6: Capital flows, overindebtedness and defaults, Part 1

Questions you may want to address in your paper: Is your country "debt intolerant," and if so why or why not? Do you think that its external debt burden is sustainable, and if so why or why not? What are the policy implications of your assessment?

Required readings:

1) Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano, "Debt intolerance," Brookings Papers on Economic Activity, #1, Spring 2003, pp. 1-74.
2) Aart Kraay and Vikram Nehru, "When is external debt sustainable?," draft, October 2003, in www.imf.org/external/np/res/seminars/2003/lic/pdf/kn.pdf

Supplementary readings:

1) Craig Burnside, editor, Fiscal Sustainability in Theory and Practice: A Handbook (Washington, DC: World Bank, 2004).
2) IMF and World Bank, "Debt sustainability in low-income countries: proposal for an operational framework and policy implications," draft, February 3, 2004, in www.imf.org/external/np/pdr/sustain/2004/020304.pdf
3) IMF, "Public debt in emerging markets: is it too high?," World Economic Outlook September 2003, pp. 113-152, in www.imf.org/external/pubs/ft/weo/2003/02/pdf/chapter3.pdf
4) Thomas Helbling, Ashoka Mody and Ratna Sahay, "Debt accumulation in the CIS-7 countries: bad luck, bad policies, or bad advice?," IMF Working Paper WP/04/93, May 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0493.pdf
5) Richard Hemming, Michael Kell and Axel Schimmelpfennig, "Fiscal vulnerability and financial crises in emerging market economies," IMF Occasional Paper #218, 2003.
6) Shogo Ishii et al., "Capital account liberalization and financial sector stability," IMF Occasional Paper #211, 2002.
7) IMF, "Access to international capital markets for first-time sovereign issuers," and "Country cases," draft, November 17, 2003, in www.imf.org/external/np/icm/2003/eng/111703.pdf and www.imf.org/external/np/icm/2003/eng/111703s1.pdf

May 13: Capital flows, overindebtedness and defaults, Part 2

Questions you may want to address in your paper: Has your government defaulted on its external debt, and if so why or why not? Do you think that your country needs debt forgiveness, and if so how should it go about getting it? What are the policy implications of your assessment?

Required readings:

1) Punam Chuhan and Federico Sturzenegger, "Default episodes in the 1980s and 1990s: what have we learned?," March 2004, in www1.worldbank.org/economicpolicy/documents/mv/pgchapter08.pdf
2) Arturo C. Porzecanski, "Dealing with sovereign debt: trends and implications," forthcoming in Chris Jochnick and Fraser Preston, editors, Sovereign Debt at the Crossroads (New York: Oxford Univ. Press, 2005).

Supplementary readings:

1) Guillermo A. Calvo, Alejandro Izquierdo and Ernesto Talvi, "Sudden stops, the real exchange rate, and fiscal sustainability: Argentina's lessons," in Volbert Alexander et al., editors, Monetary Unions and Hard Pegs: Effects on Trade, Financial Development, and Stability (New York: Oxford, 2004), pp. 151-181.
2) Caroline Van Rijckeghem and Beatrice Weder, "The politics of debt crises," CEPR Discussion Paper #4683, October 2004, in www.cepr.org/pubs/dps/DP4683.asp

3) Mark Kruger and Miguel Messmacher, "Sovereign debt defaults and financing needs," IMF Working Paper WP/04/53, March 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0453.pdf
4) Andrea Pescatori and Amadou N. R. Sy, "Debt crises and the development of international capital markets," IMF Working Paper WP/04/44, March 2004, in www.imf.org/external/pubs/ft/wp/2004/wp0444.pdf
5) Nouriel Roubini and Brad Setser, Bailouts or Bail-ins: Responding to Financial Crises in Emerging Economies (Washington, DC: IIE, 2004).
6) Graham Bird and Alistair Milne, "Debt relief for low-income countries: is it effective and efficient?," World Economy, Vol. 26 #1, January 2003, pp. 43-59.
7) Jeffrey D. Sachs, "Resolving the debt crisis of low-income countries," Brookings Papers on Economic Activity, 2002 #1, pp. 257-286.
8) IMF, "Guidelines for public debt management," draft December 9, 2003, in www.imf.org/external/np/mfd/pdebt/2003/eng/am/120903.pdf and "Country case studies," draft August 4, 2003, in www.imf.org/external/pubs/ft/pdm/eng/guide/pdf/part2.pdf