

## **Financial Policy Issues in Emerging Market Countries (ECON 295-11)**

The Elliott School of International Affairs  
George Washington University

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**Lex Rieffel**

Adjunct Professor of International Economics  
Non-Resident Senior Fellow, The Brookings Institution, Washington, DC  
1775 Massachusetts Avenue, NW

Office hours: Tuesdays by appointment

Tel: (202) 309-2478; Fax: (202) 387-1345

E-mail: [rieffel@gwu.edu](mailto:rieffel@gwu.edu), [rieffel@brookings.edu](mailto:rieffel@brookings.edu)

### **Course Description, Class Schedule, Assignments**

#### **Course Description**

Emerging market countries such as China, India, Russia, and Brazil are expected to be major sources of global economic growth in the coming decades. This seminar focuses on critical financial policy issues that will challenge the governments in the most important emerging market countries and have a major impact on their relative performance. These issues will also affect economic and political relations with the United States and other industrial countries, with internationally active businesses, and with NGOs concerned with global challenges such as poverty, terrorism, post-conflict reconstruction, loss of biodiversity, and global warming.

The seminar looks at the world through the eyes of finance ministers in the leading emerging market countries as they make choices in five areas of “internal” policy and six areas of “external” policy. The internal areas are the role of the central bank, the budget, privatization, banking sector reform, and capital market development. The external areas are the exchange rate regime and capital account liberalization, private equity flows, private debt flows, multilateral official financing, bilateral official financing, and debt restructuring. In each area, the seminar will examine the factors that push countries to adopt policies that deviate from the “ideal” policies indicated by theory and precedent.

A core concept in the seminar is the “country risk premium,” measured by the difference in the market yield between a country’s sovereign bonds and equivalent-maturity U.S. Treasury bonds. Students are expected to develop a sophisticated understanding of why this premium is important, how internal policy choices and external factors affect the premium.

The realm of emerging markets finance is in a period of transition, however. The country risk premium has become less important as international fund managers and asset managers have become increasingly willing to invest in emerging market debt instruments denominated in local currencies. Over the past couple of years, emerging market bonds have moved out of the junk bond category and are perceived to be a less

risky asset class. Another new phenomenon is the creation of “sovereign wealth funds” by emerging market countries that are accumulating “excess” foreign exchange reserves and want to earn higher returns on these reserves than they can get from investing them in “risk-free” U.S. Treasury bonds. This phenomenon underscores how far emerging market countries, as a group, have “flipped” from being debtors to creditors vis-à-vis the USA and other high-income countries.

Each student is required to select a systemically significant emerging market country at the beginning of the semester and to track how the finance minister in that country is dealing with the topic of the week. In advance of each class, students will be given a set of Class Notes on the topic to be discussed and no more than four relatively short readings. Students will write two short Policy Memos to the finance minister of the country they have selected for special study, each one recommending a specific policy measure. Students will also make a class presentation on a policy issue related to the topic of the week.

### **Course Instructor**

The seminar is offered by Lex Rieffel. Rieffel is a Non-Resident Senior Fellow at the Brookings Institution, with 25 years of experience working on financial policy issues at the U.S. Treasury Department and the Institute of International Finance (an association representing the global financial industry).

His years with the Treasury included postings on the staff of the U.S. Ambassador to the OECD in Paris (1984-86), and the staff of the U.S. Executive Director in the International Monetary Fund (1988-89). His last assignment was directing the office responsible for issues related to the transition countries in Eastern Europe and the former Soviet Union (1990-1992). He is the author of *Sovereign Debt Restructuring: The Case for Ad Hoc Machinery* (Brookings Press, 2003), “Indonesia’s Quiet Revolution” (*Foreign Affairs*, September-October 2004), and Policy Briefs on the Peace Corps (2003), the Millennium Challenge Corporation (2005), Nigeria’s Paris Club Debt Deal (2005), and International Volunteering (2006). His latest publication (co-authored) is: “Out of Business and On Budget: the Challenge of Military Financing in Indonesia”. He has taught previously at Johns Hopkins U. (SAIS) and Syracuse U. (Maxwell School).

### **Course Objectives**

The students taking this course will soon be in jobs with an international dimension. Their success will depend in part on the insights and tools they acquire during their graduate studies. This course focuses on the leading emerging market countries, the most important group of players in the world economy after the industrial powers. As a group, these rising economic powers are gaining ground on the United States, Europe, and Japan, and they are expected to be the major engines of global growth over the coming decades. The course is designed to provide students with a good grasp of the financial dimension of economic growth and development in these countries.

Within the group of leading emerging market countries, their relative performance in the years ahead will be determined by their different starting points, the policies they choose to maintain or accelerate their growth, their skill in implementing these policies, and their reaction to unpredictable shocks. For example, consider the differences between the four most important members of this group: China, India, Russia, and Brazil. They have similar goals but quite diverse historical experiences and institutional frameworks. Finance Ministers in these countries face similar issues but operate with unique constraints. Financial policies may not be the most important determinant of their country's economic performance, but they are generally a major factor.

In an increasingly integrated global economy, the financial policy choices made by the leading emerging market countries have an impact beyond their borders. This impact provides a compelling reason for understanding why specific policies have been adopted, and the implications of changes in these policies. The ability to analyze alternative policies and make the case for adopting one of them is a related skill with wide application. Students who take this course should be well prepared to make valuable contributions in their places of employment, inside a finance ministry, elsewhere in government, in a private company, in an NGO, or in academia.

### **Course Schedule and Location**

The course is scheduled to meet [in a room to be determined] from 7:10pm to 9:00 p.m. on Tuesday evenings beginning on January 15, 2008, and ending on Tuesday, April 22, except on March 18, the week of Spring Break. In addition there will be a final exam.

### **Prerequisite and Class Limit**

Unless a waiver is granted, students must have completed Economics 284 or an equivalent course in intermediate macroeconomics or international macroeconomics. The number of students in the seminar will be limited to 20.

### **Course Requirements and Student Assessment**

Preparation and active participation in class are essential. Students are expected to attend all 15 sessions. In case of a family, medical, or other emergency, students should notify the instructor of their absence in advance.

Students are expected to become familiar with basic terminology used in discussing the policy issues covered in the course, such as "country risk premium," "bank recapitalization," and "IMF conditionality." They are expected to analyze complex policy issues with economic, political, and social dimensions. They are expected to communicate the results of their analysis clearly, concisely, and persuasively, both orally and in writing. Original thinking and constructive critiques are strongly encouraged.

Grades will be based broadly on how well students meet these objectives by the end of the course. More specifically, final grades will reflect performance in the three categories described below.

### **1. Policy Memos (45 percent)**

Students are required to write two short (2-page) memos to the finance minister in the country they have selected for special study analyzing a policy choice and recommending a specific policy. A sample Policy Memo will be provided at the beginning of the course.

### **2. Class Participation (25 percent)**

Satisfactory class participation will require preparing in advance of each session, contributing relevant points, asking good questions, and reacting constructively to points made by other students. At the first class, students will be asked to declare the emerging market country they have selected for special study. The selection of countries will be discussed and agreed in class to ensure broad coverage and avoid excessive duplication. Students are expected to have some knowledge of the position of the finance minister in the country they have selected on the policy area under discussion in each class. Students are expected to review the materials on the list of Recommended Readings in advance of each session. Outstanding class participation will require consistently making points of interest to other students, asking questions that elicit useful information from the instructor or other students, and probing/challenging comments made by other students in a constructive manner.

### **3. Class Presentation (15 percent)**

Each student will also make a short presentation on an issue related to the topic of the week. Students will be paired for making presentations if more than twelve are enrolled. The best presentations will be well organized and convey information of value to the other students. A one-page handout with key points can be a useful device.

### **4. Final Examination (15 percent)**

The final examination will be for one hour and will consist mostly of short-answer questions about basic concepts discussed in the course.

### **Office Hours**

I will generally be available for consultations with students on Tuesdays at the Brookings Institution. Appointments can be scheduled by email to [Rieffel@gwu.edu](mailto:Rieffel@gwu.edu).

### **Basic References**

Two textbooks will be on reserve at the library at the beginning of the semester. Students interested in a second opinion or a more theoretical treatment of the issues covered in the course are encouraged to consult these sources.

--David Beim and Charles Calomiris, *Emerging Financial Markets*, McGraw-Hill Irwin, 2001.

--Peter J. Montiel, *Macroeconomics in Emerging Markets*, Cambridge University Press, 2003.

Copies of my book on *Sovereign Debt Restructuring* will also be on reserve in the library.

Two superb books were recently published that offer insider perspectives on emerging markets finance. John Taylor was the Treasury Under Secretary for International Affairs in the first six years of the Bush Administration. Antoine van Agtmael coined the term “emerging markets” when he was working at the International Finance Corporation in the 1980s. Both will be put on reserve in the library and students who read them will be in a position to contribute more to class discussions.

--John B. Taylor. 2007. *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World*. W.W. Norton.

--Antoine van Agtmael. 2007. *The Emerging Markets Century: How A New Breed of World-Class Companies is Overtaking the World*. Simon & Schuster.

### **Course Outline and Recommended Reading**

*The readings listed below complement the Class Notes by adding depth or offering different perspectives. Students who read thoroughly at least one of these readings each week and draw on it in the class are more likely to get higher grades.*

#### **Part I: Introduction**

##### **Week 1: The Financial Dimension of Economic Development (January 15)**

*Students are encouraged to read at least two of the following three sources before the first class.*

Hernando de Soto. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York. Basic Books. 2000 (Only Chapter III, reprinted in IMF. *Finance and Development*. March 2001.

<http://www.imf.org/external/pubs/ft/fandd/2001/03/desoto.htm>

John Williamson. "From Reform Agenda to Damaged Brand Name." *Finance and Development*, Vol. 40, No. 3. September 2003.

<http://www.imf.org/external/pubs/ft/fandd/2003/09/pdf/williams.pdf>

IMF. *World Economic Outlook—September 2005*. Only Chapter III on "Building Institutions".

<http://imf.org/external/pubs/ft/weo/2005/02/index.htm>

Lant Pritchett. "The Quest Continues". *Finance and Development*

<http://imf.org/external/pubs/ft/fandd/2006/03/pritchet.htm>

*The following three sources are recommended reading for the course but not for Week One. Updated IMF reports are expected in April. Updates of the IIF report are expected in January and April/May.*

IMF. *World Economic Outlook—October 2007*. **Only the Executive Summary and relevant parts of Chapters 2 and 3.**

<http://www.imf.org/external/pubs/ft/weo/2007/02/index.htm>

IMF. *Global Financial Stability Report*. September 2007. **Only the Executive Summary and the emerging market portions of Chapter 1.**

<http://www.imf.org/External/Pubs/FT/GFSR/2007/02/index.htm>

Institute of International Finance. *Capital Flows to Emerging Markets*. 21 October 2007.

<http://iif.com/press/press+44.php> [follow link to full document]

## Part II: Internal Financial Issues

### Week 2: The Role of the Central Bank (January 22)

IMF. *World Economic Outlook—September 2005*. **Only Chapter IV on "Does Inflation Targeting Work in Emerging Markets".**

<http://www.imf.org/external/pubs/ft/weo/2005/02/pdf/chapter4.pdf>

John B. Taylor. "Using Monetary Policy Rules in Emerging Market Economies." Paper delivered at a conference on Stabilization and Monetary Policy: The International Experience, Bank of Mexico. December 2000.

<http://www.stanford.edu/~johntayl/Papers/Bank%20of%20Mexico%20Paper2.pdf>

Bimal Jalan. "Developments in Central Banking." *Bicentennial Symposium of the Banque de France*. May 2000.

<http://www.banque-france.fr/gb/publications/telnomot/seminaires/colbicengbdd.pdf>  
[pages 233-236]

### **Week 3: The Budget (January 29)**

Vito Tanzi and Howell Zee. *Tax Policy for Developing Countries*. Economic Issues No. 27. March 2001.

<http://www.imf.org/external/pubs/ft/issues/issues27/index.htm>

IMF. "Chapter 3: Public Debt in Emerging Market Economies: Is It Too High?" *World Economic Outlook*. September 2003.

<http://www.imf.org/external/mmedia/view.asp?eventID=204> [7-minute webcast]

*Reading one of the following two items will be sufficient.*

Jack Diamond. *Reforming the Russian Budget System: A Move to More Devolved Budget Management?*. IMF Working Paper No. 05/104. May 2005

<http://www.imf.org/external/pubs/ft/wp/2005/wp05104.pdf>

Catriona Purfield. *The Decentralization Dilemma in India*. IMF WP/04/32. March 2004

<http://www.imf.org/external/pubs/ft/wp/2004/wp0432.pdf>

### **Week 4: Privatization (February 5)**

OECD. OECD Guidelines on Corporate Governance of State-Owned Enterprises. 2005

<http://www.oecd.org/dataoecd/46/51/34803211.pdf>

*Financial Times*. Series of stories on privatization. May 2005. (Posted on the Blackboard)

IMF. Fiscal Affairs Department. *Public-Private Partnerships*. March 2004.

<http://www.imf.org/external/np/fad/2004/pifp/eng/031204.pdf>

### **Week 5: Banking Sector Reform (February 12)**

James A. Hanson. "The Transformation of State-Owned Banks." In Caprio et al. *The Future of State-Owned Financial Institutions*. Brookings Institution Press. 2004. pp. 13-49. (Posted on the Blackboard)

IMF. *Staff note on Basel II: Guidance for Fund Staff*. April 23, 2004.

<http://www.imf.org/external/np/mfd/2004/eng/042304.htm>

and Factual Update, 20 October 2005

<http://www.imf.org/external/np/pp/eng/2005/102005.htm>

Chungwon Kang. "View from the Inside." *Finance and Development*. IMF. June 2004. (firsthand account of the restructuring and privatization of Seoul Bank)

<http://www.imf.org/external/pubs/ft/fandd/2004/06/pdf/kang.pdf>

## **Week 6: Domestic Capital Market Development (February 19)**

### **\*\*\* FIRST POLICY MEMO DUE**

Litan et al. (eds.). *The Future of Domestic Capital Markets in Developing Countries*. Brookings Institution Press. 2003.

- Skim the “Introduction” by Litan et al, pp. 1-20.
- Read Chapter 2 on “Trends in Developing-Country Capital Markets Around the World” by Hausler et al., pp. 21-45. It is dated now, which shows how fast the ground is changing in this area.
- Skim Chapter 13 on “Identifying Vulnerabilities, Promoting Financial Stability, and Other Challenges” by Conroy and Petersen, pp. 347-364, which focuses on the performance of EMC equity markets against the standards of the International Organization of Securities Commissions (IOSCO).
- **Scanned copies of these three chapters are on the Blackboard.**

IMF. “Developing Deeper Capital Markets in Emerging Market Economies.” Remarks by John Lipsky First Deputy Managing Director, IMF, at the U.S. Department of the Treasury on February 5, 2007.

<http://www.imf.org/external/np/speeches/2007/020207a.htm>

IMF. “Financial Sector Assessment Program Updates: Frequently Asked Questions.” October 2005.

<http://www.imf.org/external/np/fsap/faq/index.htm>

## **Part III: The Country Risk Premium**

### **Week 7: The Country Risk Premium (February 26)**

IMF. *Investor Relations Programs—Recent Developments and Issues*. October 26, 2004.

<http://imf.org/external/np/icm/2004/102604.htm>

Institute of International Finance (IIF). *Investor Relations: An Approach to Effective Communications and Enhanced Transparency—2005 Assessments of Key Borrowing Countries*. November 2005.

*This report is 301 pages long. It can be found via the following link:*

<http://iif.com/emp/ir/>

Institute of International Finance (IIF). *Investor Relations: Update of Key Borrowing Countries*. September 2006.

*This report is 35 pages long. It can be found via a link on the same web page as the preceding report.*

#### **Part IV: External Financial Issues**

##### **Week 8: Exchange Rate Regimes and Capital Account Liberalization (March 4)**

Alan Taylor. "Global Finance: Past and Present." IMF. *Finance and Development*. March 2004.

<http://www.imf.org/external/pubs/ft/fandd/2004/03/pdf/taylor.pdf>

IMF. 2004. *World Economic Outlook—September 2004*. Chapter 2: Three Current Policy Issues. Second Issue: "Learning to Float: The Experience of Emerging Market Countries Since the Early 1990s." Pp. 89-103.

<http://www.imf.org/external/pubs/ft/weo/2004/02/pdf/chapter2.pdf>

OECD. October 2002. *Forty Years' Experience with the OECD Code of Liberalization of Capital Movements: Summary and Conclusions*. (Posted on the Blackboard.)

IMF. May 2005. *Report of Independent Evaluation Office on the IMF's Approach to Capital Account Liberalization*.

<http://imf.org/External/NP/ieo/2005/pr/eng/pr0502.htm>

*The following reading is optional, except for students who have picked China as their country for special study. This is an excellent introduction to the "hot" topic of China's exchange regime, even though it was published before the August 2005 move to a "flexible" regime.*

Prasad et al. *Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China*. IMF. Policy Discussion Paper PDP/05/1. January 2005

<http://imf.org/external/pubs/ft/pdp/2005/pdp01.pdf>

##### **Week 9: Private Capital Flows I—Equity Flows (March 11)**

OECD. *Policy Brief: Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*. October 2002.

<http://www.oecd.org/dataoecd/61/12/2763043.pdf>

IMF. *World Economic Outlook--April 2005*. Read only Chapter II on "remittances".

<http://www.imf.org/external/pubs/ft/weo/2005/01/pdf/chapter2.pdf>

Wanda Tseng and Harm Zebregs. *Foreign Direct Investment in China: Some Lessons for Other Countries*. IMF Policy Discussion Paper No. 02/3. February 2002.

<http://imf.org/external/pubs/ft/pdp/2002/pdp03.pdf>

## SPRING BREAK (March 18)

### Week 10: Private Capital Flows II—Debt Flows (March 25)

IMF. *Global Fin Stability Report*, April 2004. **Chapter 4 only** (“Institutional Investors in Emerging Markets”)

<http://imf.org/external/pubs/ft/GFSR/2004/01/pdf/chp4.pdf>

Christina Daseking. “Debt: How Much Is Too Much.” *Finance and Development*. December 2002.

<http://www.imf.org/external/pubs/ft/fandd/2002/12/daseking.htm>

IMF. *Sovereign Borrowing by Developing Countries: What Determines Market Access?* Working Paper No. 04/221. November 2004

<http://imf.org/external/pubs/ft/wp/2004/wp04221.pdf>

### Week 11: Official Flows I—Multilateral Sources (April 1)

Vijay L. Kelkar, Praveen K. Chaudhry, and Marta Vanduzer-Snow. “Time for Change at the IMF.” *Finance and Development*. March 2005.

<http://imf.org/external/pubs/ft/fandd/2005/03/pdf/kelkar.pdf>

**Note: The Annual Reports listed below can be found in the Reference section of the GWU Library.**

*Explore the following report to find information about the country you have selected for special study, including its quota, its use of fund resources, its Governor, and its Executive Director.*

*IMF Annual Report—2007.*

<http://www.imf.org/external/pubs/ft/ar/2007/eng/index.htm>

*Explore the following reports to find out what role these parts of the World Bank Group are playing in the country you have selected:*

- World Bank Annual Report 2007  
<http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/EXTANNREP>

[/EXTANNREP2K7/0,,menuPK:4078239~pagePK:64168427~piPK:64168435~theSitePK:4077916,00.html](#)

- International Finance Corporation Annual Report 2007  
<http://www.ifc.org/ifcext/annualreport.nsf/content/Home>
  - 
  - Multilateral Investment Guarantee Agency Annual Report 2007  
<http://www.miga.org/index.cfm?aid=746>
  -
- Explore **one** of these reports to find out what role the relevant regional development bank is playing in the country you have selected:*
- Asian Development Bank Annual Report 2006 (The 2007 report should be out in May.)  
[http://adb.org/Documents/Reports/Annual\\_Report/2006/default.asp?p=aadb](http://adb.org/Documents/Reports/Annual_Report/2006/default.asp?p=aadb)
  - European Bank for Reconstruction and Development Annual Report 2006  
<http://www.ebrd.com/pubs/general/ar06.htm> (The 2007 report should be out in April.)
  - Inter-American Development Bank Annual Report 2006.  
<http://www.iadb.org/exr/ar2006/index.cfm?language=english> (The 2007 report should be out in March.)

## Week 12: Official Flows II—Bilateral Sources (April 8)

### \*\*\* SECOND POLICY MEMO DUE

Benedict Clements, Sanjeev Gupta, Alexander Pivovarsky, and Erwin R. Tiongson. "Foreign Aid: Grants vs. Loans." *Finance and Development*. September 2004.  
<http://imf.org/external/pubs/ft/fandd/2004/09/pdf/clements.pdf>

OECD. *Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results, and Mutual Accountability*. 2 March 2005.  
<http://www.oecd.org/dataoecd/11/41/34428351.pdf>

Gary Hufbauer and Rita Rodriguez (Eds). *The Ex-Im Bank in the 21<sup>st</sup> Century: A New Approach?* IIE, January 2001. **Read only 2 or 3 chapters of greatest interest.**  
[http://bookstore.iie.com/merchant.mvc?Screen=PROD&Product\\_Code=323](http://bookstore.iie.com/merchant.mvc?Screen=PROD&Product_Code=323)

James W. Fox and Lex Rieffel. *The Millennium Challenge Account: Moving Toward Smarter Aid*. Policy Brief No. 145. Brookings Institution. August 2005/.  
[http://www.brookings.edu/papers/2005/08development\\_rieffel02.aspx](http://www.brookings.edu/papers/2005/08development_rieffel02.aspx)

### Week 13: Debt Restructuring (April 15)

Raghuram Rajan. "Odious or Just Malodorous." *Finance and Development*. December 2004.

<http://imf.org/external/pubs/ft/fandd/2004/12/pdf/straight.pdf>

Lex Rieffel. *Restructuring Sovereign Debt: the Case for Ad Hoc Machinery*. *Brookings Institution Press*. 2003. **First four chapters only.** [Posted on the Blackboard]

Institute of International Finance. *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*. March 2005. [Posted on the Blackboard]

Paris Club web site: [www.clubdeparis.org](http://www.clubdeparis.org).

- **Look at the operations involving your country, if there were any.**
- **Look at the presentations given at the May 23, 2007, Paris Club meeting with private sector representatives.** <http://www.clubdeparis.org/cdp/sections/secteur-prive/presentations-effectuees>

### Week 14: Sovereign Debt Funds (April 22)

Edwin M. Truman. "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability". Peterson Institute for International Economics. Policy Brief 07-6. 2007.

<http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=783>

## Part V: Conclusion

### Week 14: The Architecture of the International Financial System (April 29)

Raghuram Rajan. F&D. March 2005. "Rules versus Discretion." *Finance and Development*. March 2005.

<http://imf.org/external/pubs/ft/fandd/2005/03/pdf/straight.pdf>

IMF. Monetary and Financial Systems and Legal Departments. *Anti-Money Laundering and Combating the Financing of Terrorism: Observations from the Work Program and Implications Going Forward*. August 2005

<http://imf.org/external/np/pp/eng/2005/083105.htm>

*The following reading is included on the syllabus, but it is a bit outdated now. For students who have a special interest in this area, it may be worth reading because the author is probably the most highly regarded academic focusing on the "architecture" issue.*

Barry Eichengreen. "Strengthening the International Financial Architecture." Address to Annual PECC Finance Conference, Santiago, Chile, June 2004

<http://emlab.berkeley.edu/users/eichengr/policy/pecc-santiagojun23-04.pdf>

**Week 14: Final Examination (May 6--tentative)**