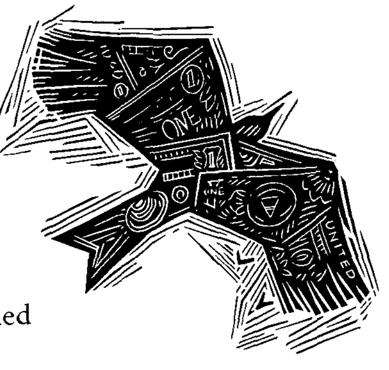
Capital Mobility

Ties Need Not Bind

By Barry Eichengreen



Imported capital helped fuel the great boom in East Asia. But capital flight now threatens to drive emerging markets back to poverty. Is there a way to save the baby while jettisoning the bath water?

Since the Asian crisis erupted, Indonesia has been wracked by unrest and President Suharto has been driven from office. But in neighboring Malaysia, Prime Minister Mahathir Mohamed responded to the same crisis in a radically different way, imposing a curfew on capital rather than on unruly students.

Once the home of wide-open financial markets and a highly capitalized stock market, Malaysia now controls both purchases and sales of its currency. Not just banks and stock brokers are affected: Citizens are prohibited from taking as little as $100 out of the country, and the law is enforced by random searches at the airport.

Mahathir argues that this infringement on civil liberties, the financial equivalent of a dusk-to-dawn curfew, is needed to protect Malaysia from marauding hedge funds that mug innocent bystanders. It would be madness, in his view, to leave currency speculators unrestrained, jeopardizing the health of the economy.

SCOTT BALDWIN (4)

Capital controls, it seems, are back in fashion. Paul Krugman of M.I.T. recently argued in *Fortune* magazine that emergency conditions warranted emergency measures. Asserting that the Asian countries experiencing the crisis were collapsing, he urged them to consider controls as shelter from the storm. His argument was seen, rightly or wrongly, as giving Mahathir intellectual cover for his unorthodox initiative. Meanwhile, Dani Rodrik of Harvard issued a blanket indictment of capital market liberalization. Rodrik asserted there is no evidence that countries allowing free capital flows actually grow faster, while it was self-evident that international liberalization exposed them to financial panic.

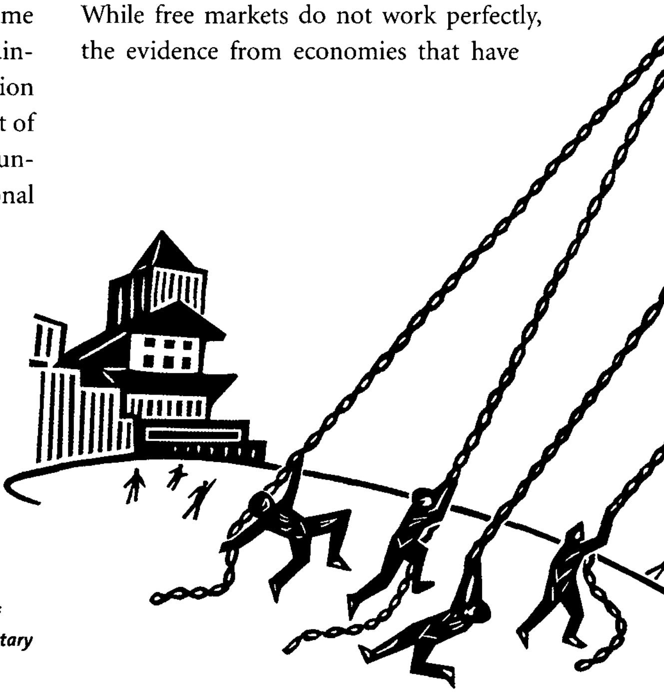
This apostasy, flying in the face of all that is sacred to economists, has predictably provoked harsh criticism. Economists presume that markets know better than governments and that, left to their own devices, markets allocate resources reasonably well. Yet the suspicion remains that there is something different about international financial markets.

Harry Dexter White and John Maynard Keynes, the founding fathers of what became known as the Bretton Woods system, certainly thought so. While supporting liberalization in principle, the Bretton Woods Agreement of 1945 permitted – indeed, encouraged – countries to retain restrictions on international financial transactions. Only in recent years, in response to pressure from the International Monetary Fund and the United States, have governments (first in Europe and Japan, and later in most emerging markets) abandoned capital controls. The Asian crisis suggests that at least in the case of developing economies, this was a serious mistake.

Stepping back a bit, it is far from clear why international financial transactions should be treated differently from other transactions or why the presumption that markets know better than bureaucrats is invalid. Is the operative word here "financial" or is it "international"? Are capital controls simply to be tolerated as emergency measures, or should they be retained as permanent protection against fickle investors? Should they be on the agenda of all relatively open economies or only emerging markets? Unfortunately, the discussion to date has confused these issues more than it has illuminated them.

THE FUNDAMENTAL CASE FOR FINANCIAL LIBERALIZATION

Perhaps the most basic insight of modern economics is that self-interested economic actions maximize collective interest – or, to put the point more simply, that markets allocate resources in socially desirable ways. While free markets do not work perfectly, the evidence from economies that have



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tried alternatives (everything from protective tariffs to promote industrialization in Latin America to central planning in the Soviet Union) suggests that free markets produce better outcomes than bureaucrats.

There is no obvious reason why this presumption should apply less to financial markets than to other markets. Indeed, studies by the World Bank have consistently shown that countries with more developed financial markets grow faster. By the same token, experience with policies of repression in developing countries and with state monopolies over transactions in the former Soviet bloc shows that stifling financial markets can inhibit growth.

What works best for domestic finance ought to work for international finance, too. Consider the advantages: international capital markets allow the transfer of resources from high-saving markets to low-saving ones; they allow economies experiencing business-cycle disturbances to buffer abrupt changes in consumption and investment, and they allow companies and households to protect against risk by diversification.

With so strong a presumption in favor of free markets, counter-arguments had better be based on incontrovertible evidence. And Rodrik's research is widely cited as the smoking gun: Using data from a cross-section of countries, he finds no statistical link between capital flows and economic growth – proof, he argues, that capital mobility has not driven

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economic development.

Well, hardly proof. Statisticians may fail to find a relationship between capital account liberalization and growth, not because none exists but because they have inadvertently omitted other variables that are negatively associated with growth but positively associated with the political decision to open capital accounts. It is plausible that countries deciding to keep their capital accounts open differ in other ways – including ways which statisticians cannot account for.

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The Rodrik research is thus what Jeffrey Frankel of the President's Council of Economic Advisers refers to as "fail-safe" econometrics. In his words, "the secret of empirical work is to define your hypothesis so that failure to find significant results can be interpreted as support."

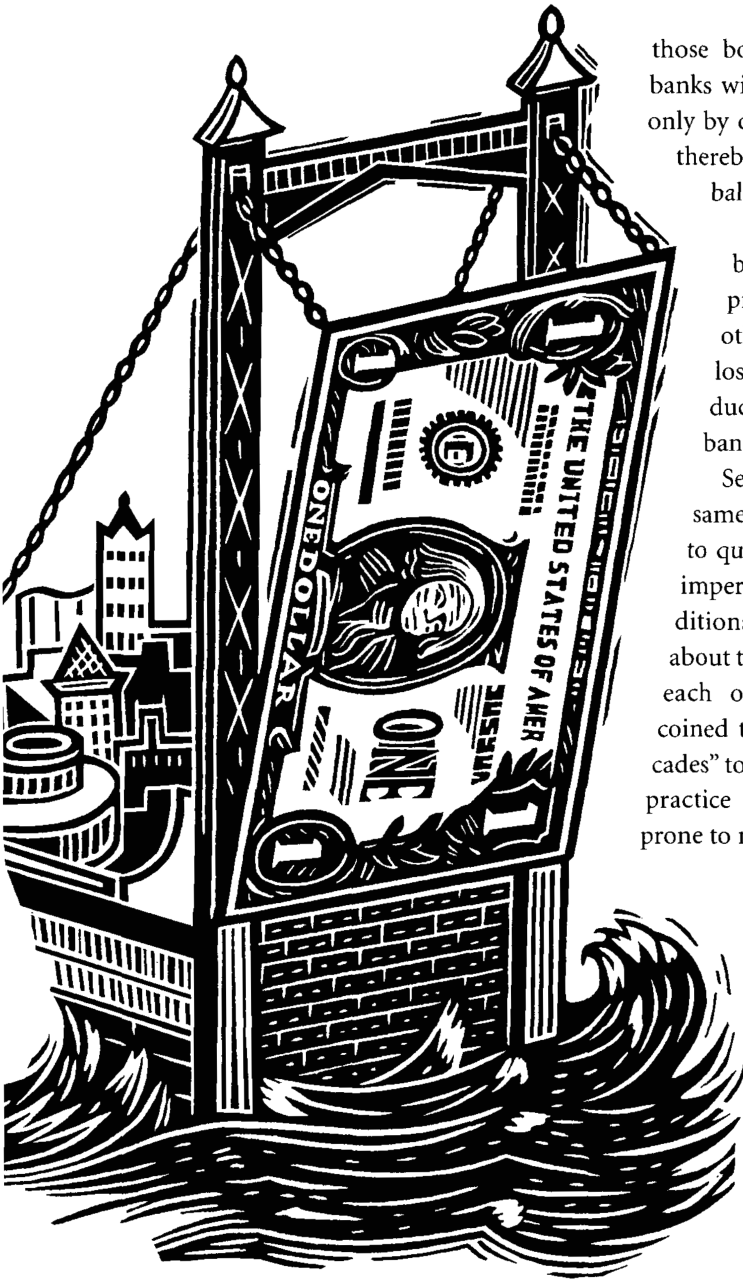
In a sense, those who argue that today's developing countries should reject capital mobility are adopting something of a double standard. All of today's advanced industrial economies have opened their capital accounts. And all of them have made their currencies convertible for purposes of investment. This is the logical culmination of developing a deep, mature and efficient domestic financial system. For domestic and international financial liberalization do go together: It is very hard to liberalize domestic financial transactions, yet keep a lid on cross-border transactions. Some would go a step further, arguing that capital account liberalization is part and parcel of political liberalization. Capital controls, needless to say, infringe on economic freedom and are not a regime under which most readers of this article would themselves prefer to live.

But absolutists on both sides miss some critical nuances. I would agrue that it makes sense for developing countries to control capital flows while they build diversified financial systems, upgrade supervision and strengthen their monetary and fiscal institutions. These should be transitional measures, though: there is no better case for permanent control in developing economies today than in the now-rich economies that wrestled with similar problems long ago.

CAPITAL CONTROLS AS PRUDENTIAL MEASURES

Markets may be the best means we have for allocating financial resources, but history has also shown that they can be dangerously unstable. Like a trapeze artist, the financial system can perform miraculous tricks, yet experience catastrophe if allowed to perform without a net.

Banks in particular share the circus performer's vulnerability. Their investments are almost invariably less liquid than their deposits. And they must operate with less-than-perfect information. Indeed, one of



their basic functions is to develop long-term relationships with clients as a way of acquiring information about their borrowers' credit worthiness.

But the reality that other potential creditors will not have equally good information about those borrowers virtually guarantees that banks will be able to raise funds in a crisis only by dumping assets at fire-sale prices – thereby doing further damage to their balance sheets.

What's more, banks do extensive business with one another. Hence, problems in one create problems in others. For all these reasons, a sudden loss of depositor confidence can produce a panic that brings the entire banking system to its knees.

Securities markets share many of the same vulnerabilities. Investors are prone to quick, collective reactions. And being imperfectly informed about market conditions, they tend to make inferences about the real value of their securities from each other's actions. Economists have coined the elegant term "information cascades" to denote this phenomenon, which in practice simply means that investors are prone to moving in herds.

Moreover, investors often borrow to increase their financial leverage, so that when markets move against them they must put up additional collateral. They can thus be forced to sell into a falling market, amplifying price volatility. And a large price fall can bring commercial lenders down, threatening the flow of credit for the "real" economy. The case of Long-Term Capital Management reminds us that this scenario is not merely hypothetical.

That's why governments impose ceilings on concentrated investments and positions in foreign exchange, and why they limit the amount of margin money that stock buyers are allowed to use. And that's also why they do not allow banks to walk the high wire without a net – typically, a combination of deposit insurance and access to a government lender of last resort.

Open and unregulated international capital flows pose special risks in this context. If banks borrow in foreign currency, they undermine their regulators' ability to act as lenders of last resort. After all, a central bank can't print foreign currency, and its capacity to provide commercial banks the foreign exchange needed to make good on their foreign obligations is limited to its own reserves of foreign currency.

Even if private bank debts are all owed in domestic currency, a central bank trying to defend the exchange rate in the midst of a crisis will find itself between a rock and a hard place. It must choose between draining liquidity from the markets (raising interest rates) to defend the exchange rate or injecting liquidity (lowering interest rates) to defend the banks.

Don't misunderstand: In a well-working market economy, risk management is first and foremost the responsibility of bank owners and managers themselves. They are the ones making the investment decisions, and they should bear the consequences. Indeed, the best reason to force banks to hold capital reserves is to guarantee that their owners have something to lose from bad decisions.

Regulators form a second line of defense against excessive risk-taking. They can monitor banks balance sheets and take corrective action when they find fraud, incompetence or evidence that bank owners are taking huge risks to dig their way out of insolvency.

But where risk-management practices are underdeveloped and the regulators lack political will or administrative capacity, it usually makes sense to build a third line of defense – to limit risk-taking by limiting the banks' ability to borrow abroad. And where corporations can borrow abroad without banks as intermediaries, it may be necessary to control all capital flows – or tax them, the way Chile does.

After Mexico in 1994 and Asia in 1997, do we need a third reminder of the dangers of premature financial liberalization?

Capital controls can only be justified as a means of containing risk if they do not arbitrarily discriminate in favor of some borrowers – say, the finance ministers' children – over others. Moreover, they are justifiable only where financial markets are thin, the private sector's risk-management practices are underdeveloped, and the regulators' capacity to supervise the financial sector is limited — in other words, where the conventional defenses against systemic risk are inadequate. In practice, though, these last three conditions (and therefore the argument for capital-inflow controls), apply to the vast majority of developing countries. Wide-open capital accounts should be the exception in emerging markets, not the rule.

Eventually, financial markets will deepen, bankers will learn to manage risk and regulators will gain competence and independence. At that point, restrictions on foreign borrowing should be removed. But here, as in other forms of financial regulation, it is smart to err in the direction of caution – to be certain that the system works before opening the doors to foreign capital. After Mexico in 1994 and Asia in 1997, do we really need yet a third reminder of the dangers of premature financial liberalization?

CAPITAL CONTROLS AS EMERGENCY MEASURES

From Thailand to Indonesia to Korea to Brazil, countries have been forced to respond to panic and the resulting recessionary pressures by cutting their budget deficits – not by increasing them, as the textbook Keynesian advice would suggest. The single greatest insight of the Keynesian revolution, namely the importance of fiscal stabilizers, has thus been thrown out the window.

Some (like Jeffrey Sachs of Harvard) say this simply reflects bad advice by the I.M.F., which required budget cuts in Asia as a condition for official loans, and which is now demanding the same of Brazil. In fact, the fund is merely mirroring market sentiment. If a country like Brazil were to respond to slower economic growth by cutting taxes and increasing public spending, investors would flee, the currency would crash and the resulting financial distress would only make the recession worse. Thus, market discipline is perverse. As Paul Krugman puts it: "Brazil, we are informed, must suffer a recession because of its unresolved budget deficit. Huh? Since when does a budget deficit require a recession?"

This bizarre state of affairs explains in part

why Mahathir imposed capital controls: without restraints on capital flight, Malaysia could not use expansionary fiscal policy to offset recession. And it is the argument that has led otherwise-orthodox free marketers to advocate controls in the teeth of crisis.

Controls do have costs: they require a burdensome administrative bureaucracy, reduce the pressure for policy reform and interrupt access to foreign sources of investment finance. But their benefits may still dominate if they restore the efficacy of expansionary policy tools.

Whether this is a sensible argument hinges on how markets view government efforts to stimulate the economy. If investors are inclined to panic when the government acti-

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vates its macroeconomic stabilizers, it can be sensible for countries to use controls to contain their individually rational but collectively destructive behavior. If, on the other hand, investors respond negatively because they view controls as the government's substitute for tough, enduring reform, then the only practical response is for the government to clean up its act.

The latter argument goes like this. Some governments lack fiscal discipline and are perennially coping with the consequences. Like an overweight man, they are continually trying to teach themselves to stay away from the refrigerator. If the fat man says, "I've had a lousy day; I'm going make myself feel better by having a piece of cake," his friends are likely to revise their estimates of the likelihood that he will stick to his diet.

Likewise, governments with a history of fiscal laxity that have a lousy macroeconomic day and respond by increasing their budget deficits similarly run the risk of being re-evaluated in this way – of being seen as having reverted to their bad old habits of living beyond their means. And if investors expect budget deficits to be financed by printing money, then deficits today imply inflation tomorrow, encouraging the rational investor to take the first opportunity to get his assets out of the country.

This explains the paradox that deficit spending in the United States strengthens the currency while deficit spending in Brazil weakens it. In the case of the United States, no one expects the Fed to print money to cover the budget deficit. Hence, additional government spending pushes up the exchange rate along with interest rates, as investors buy dollars for the higher return. In the Brazilian case, however, monetization is a real possibility (pun intended), implying more inflation and ultimately the need to allow the currency to depreciate.

It is also why another textbook response to recession – devaluing the currency in order to increase demand for goods made at home – can have catastrophic effects in emerging markets. Countries weaning themselves from inflation often do so by pegging the exchange rate, which ties the hands of the central bank and signals that the inflation will no longer be the path of least resistance. The currency peg is thus the metaphoric lock on the refrigerator. And countries that devalue are seen as candidates for relapse to inflationary excess.

The best solution in this latter case is not to impose capital controls but to eliminate the problems leading to the excesses in monetary and fiscal policies in the first place. And the most convincing way to signal that future policies will be sound is to reform the economic and political arrangements by which they are made.

A slew of research shows quite convincingly that better policy-making institutions produce better outcomes. Not surprisingly, central banks that are insulated from politics are better able to resist popular pressures to finance budget deficits the easy way – by running the printing press – and are generally more successful at stabilizing prices.

There are parallel arguments for creating an independent national fiscal council constitutionally empowered both to set a ceiling for the government budget deficit and to enforce the budget discipline. By the same token, less ambitious reforms that vest more fiscal power in the hands of the prime minister or finance minister (thereby eliminating the nobody-in-charge syndrome common to governments with autonomous ministries) are statistically associated with smaller deficits. Even measures that enhance the transparency of budgeting, making it easier for voters to identify the fiscal culprits, are likely to produce better outcomes.

With such reforms in place, markets will not conclude that deficits today necessarily mean deficits tomorrow, or that monetary expansion today means monetary expansion tomorrow. Indeed, the discretion to use fiscal and monetary policies as a counterweight to the business cycle will be regained, and capital mobility will no longer be a disaster waiting to happen.

Rewriting the rules to deliver better outcomes needn't take forever. A simple law – or better, a constitutional amendment – establishing the independence of the central bank, appointing its governors to long terms in office and reining in the fiscal autonomy of the spending ministries can be adopted in short order.

Time may be required for the new institutions to establish a track record of delivering sound macroeconomic policies. Still, Argentina's example suggests that this can be accomplished in a matter of a few years. Argentina, after all, moved from being an inflationary basket case and a capital-market pariah to one of the few emerging economies able to float bonds on international markets and to avoid excessive belt-tightening in the global turbulence of 1998.

What, then, are we to make of the debate over capital controls? Pragmatism is the order of the day.

Developing countries are simply not ready for prime time. Their regulators lack administrative ability. Their financial markets are shallow. They cannot borrow abroad in domestic currency. And so long as these problems are defining features of emerging markets, there will be solid arguments for capital controls to limit risk and to make room for monetary and fiscal stimulus in a slump.

With time, though, developing countries do develop. Their financial and regulatory institutions become more robust, and the case for capital controls grows ever weaker. Indeed, while it is true that premature liberalization has proved costly in Asia and Latin America, it would be a sad irony if capital controls become an excuse for slowing the institutional reforms so critical to insuring their long-term prosperity.

Mis-Planned

Parenthood

The Unintended Consequences of China's One-Child Policy

By Nicholas Eberstadt