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Special Issue

CAPITAL ACCOUNT LIBERALIZATION: A VIEW FROM DEVELOPING COUNTRIES

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INTRODUCCIÓN DE LOS EDITORES

Este Número Especial de *Estudios de Economía* está dedicado a explorar diversas facetas de un tema muy oportuno: la liberalización de los flujos internacionales de capital y sus efectos potenciales sobre los países en desarrollo. Las sucesivas crisis financieras internacionales que los países en desarrollo han debido enfrentar desde comienzos de la década de los ochenta han colocado a este tema en el centro de las discusiones de política económica internacional. Algunos de los trabajos que se incluyen en este Número Especial fueron presentados originalmente en un Panel sobre Liberalización de la Cuenta de Capital y Desarrollo, el cual tuvo lugar en Santiago el 15 de agosto de 1997 en el marco de la XV Reunión Latinoamericana de la Sociedad Econométrica, auspiciada por el Departamento de Economía de la Universidad de Chile. Uno de los Editores Invitados de este Número Especial (Manuel R. Agosin) ofició de moderador del Panel. Los participantes fueron Ricardo Ffrench-Davis (CEPAL, también Editor Invitado), John Williamson (Banco Mundial), Toru Yanagihara (Universidad de Hosei y Universidad de Naciones Unidas) y Harvey Rosenblum (Banco de la Reserva Federal de Dallas). El Centro de Economía Internacional y Desarrollo (CENDES) de la Facultad de Ciencias Económicas y Administrativas de la Universidad de Chile fue responsable de la organización del Panel y de la preparación de este Número Especial.

INTRODUCTION BY THE EDITORS

This Special Issue of *Estudios de Economía* is devoted to a particularly timely topic: the liberalization of international financial flows and its potential effects on developing countries. The successive international financial crises that developing countries have had to face since the beginning of the 1980s have placed the issue in the forefront of policy and academic discussions in the area of international finance. Some of the papers in the Special Issue were presented originally at a Panel on Capital Account Liberalization and Development held on August 15, 1997, during the Fifteenth Meeting of the Latin American Chapter of the Econometric Society, held in Santiago and hosted by the Department of Economics of Universidad de Chile. One of the Invited Editors

FINANCIAL LIBERALIZATION AND DEVELOPMENT: A VIEW FOR EMERGING ECONOMIES

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Thematic Introduction

This special volume of Estudios de Economía is devoted to issues of international finance in emerging economies. Finance was at the heart of the debt crisis of the 1980s. It was also a leading force in the Tequila crisis, and now it has played a crucial role in the present crisis of some countries in South-East and East Asia. In this volume we will leave the papers to speak for themselves. Here we will only present briefly a discussion of some analytical issues, sketch some features of the Airs of Crisis blowing from Asia, and explore some relevant policy lessons emerging from recent events.

Introducción Temática

Este Número Especial de Estudios de Economía está dedicado a la temática de las finanzas internacionales en las economías emergentes. Las finanzas estuvieron al centro de la crisis de la deuda en la década de los ochenta. También fueron la causa principal de la crisis del Tequila a fines de 1994 y ahora están jugando un papel crucial en la crisis que están viviendo los países del Este de Asia. En este volumen dejaremos que los trabajos hablen por sí mismos. Los objetivos de este trabajo son hacer una presentación breve de los temas analíticos involucrados, esbozar algunas de las características de los Vientos de Crisis que soplan desde el Asia y explorar algunas lecciones relevantes de política económica que se desprenden de los acontecimientos recientes.

1. SOME ANALYTICAL FEATURES

The discussion on how to deal with international financial markets has been dominated by dogmatic attachment to the principle that free markets are always best and by an idealized and simpleminded view of how financial markets operate. Those who advocate complete freedom of capital movements across borders draw an analogy with trade in goods: under most circumstances, free trade can be shown to maximize welfare. If capital movements are merely viewed as

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inter-temporal trade, there would be little difference between international trade in goods and services and international capital movements. The price for inter-temporal transactions is, of course, the interest rate. Under certain extreme assumptions, complete freedom of international capital movements would tend to close national interest rate differentials, much in the same way as free trade in goods equalizes the prices of goods in different national markets.

Several benefits are claimed for free international capital movements (see Eatwell, in this volume). From the point of view of recipient developing countries, it is claimed that access to international saving allows domestic investors to tap new sources of funding and, to the extent that firms face financing constraints to investment, it will increase the investment rate.[1] Second, the cost of borrowing will probably decline, as interest rates in international financial markets tend to be considerably lower than domestic rates. This, it is claimed, will raise investment rates and growth. Third, international finance can assist a country in smoothing its inter-temporal pattern of consumption. When a country is open to international financial flows, it becomes unnecessary to finance entirely an increase in investment with a rise in domestic saving (and, hence, a decline in consumption). It can resort to foreign saving, which it can repay out of the proceeds of higher incomes in the future.

While some of these benefits could well arise from capital account liberalization, it should be noted that they are neither automatic nor the only necessary outcome. In the first place, for investment and growth rates to rise, foreign resources must be invested rather than consumed. Furthermore, in order to ensure that future outflows of interest (or dividends) and amortization of debt (or repatriation of capital), the increase in investment must take place in the tradable sector (see ECLAC, 1995, chapter X, for an elaboration of these arguments).

Recent events in the developing world, and particularly in Latin America, are a good testing ground for the hypothesis that opening up to foreign capital enhances investment and growth. Since the mid-1980s, in the hope of attracting foreign capital, most Latin American countries have liberalized very significantly (in some cases completely) their capital accounts. At the same time, exogenous factors - especially the sharp decline in interest rates in the United States and the new "emerging markets" fad among institutional investors in developed countries - caused a surge of foreign capital inflow into most Latin American countries (Calvo, Leiderman, and Reinhart, 1993). Whereas Latin American countries had suffered a drought of foreign capital in the 1980s, seriously undermining their growth efforts, during the 1990s they have experienced the opposite problem: being awash in a sea of foreign capital that cannot be productively absorbed in the form of higher investment. Foreign capital inflows have reached between 5 and 10 per cent of GDP in a number of countries (Argentina, Brazil, Chile, and Mexico). After a short hiatus following the Mexican crisis of December 1994, foreign capital inflows resumed strongly in 1996 and 1997.

1 Several authors have found that firms face significant liquidity constraints in financing investment expenditures (see Fazzari, Hubbard, and Petersen, 1988 ; Agosin, Crespi, and Letelier, 1997). However, opening up the economy to foreign capital is unlikely to change the situation except for large firms from countries that are considered creditworthy.

Has this surge in capital inflow led to a generalized increase in investment rates? The answer is an emphatic "no". Recent evidence shows beyond doubt that the unrestricted opening to international financial markets does not lead to a rise in investment and that, instead, it tends to depress domestic saving. For investment to rise without adversely affecting domestic saving, more active policies toward foreign capital inflows are needed.

It is useful to compare two paradigmatic cases: Chile, where investment has risen systematically during the 1990s and where the authorities have adopted a pragmatic approach towards the management of capital inflow; and Mexico, where capital account liberalization has been almost unrestricted but whose investment rate has stagnated. In Mexico, the main effect of capital inflow has been an increase in consumption and a decline in domestic saving.

In Chile, about 60 per cent of all inflows have taken the form of foreign direct investment (FDI). Since 1991, the Chilean monetary authorities have attempted to discourage short-term and portfolio inflows (viewed as speculative and easily reversible) through the imposition of reserve requirements on foreign credits and foreign financial investments (see Agosin and Ffrench-Davis, in this volume). In addition, rather than using a nominal anchor, exchange rate policy has attempted to keep the price for the US dollar within a "crawling band", with a central rate fixed by reference to the price of a basket of currencies. The rate of crawl has depended on the inflation differential between Chile and its major trading partners. The band, which has been increasingly widened (it now stands at 12.5 per cent around the central rate), and dirty floating within it, has been meant to create exchange rate uncertainty so as to discourage speculative capital inflows. The third aspect of inflow management has been a policy of vigorous sterilised intervention in foreign exchange markets. Finally, banking supervision, which includes a requirement of matching assets and liabilities denominated in foreign currencies, has prevented excessive borrowing in foreign exchange to lend in domestic currency.

To the extent that short-term and portfolio flows have not been dominant in total capital inflows, as they have been in other countries, including Mexico, it can be said that Chilean policies have been successful in preventing the excesses that are associated with financial capital inflows. This is not to say that these two types of inflows have not been present. In effect, the interest of investors (both real and financial) in Chile has been so strong that large portfolio and credit flows have taken place even in spite of the reserve requirement system. In fact, in spite of the authorities' desire to maintain the exchange rate within a band (that moves upwards in nominal terms through time), they have been forced to revalue the central rate on a couple of occasions, and the market exchange rate has stuck to the floor of the band. The real exchange rate has in fact appreciated considerably over the past six years, particularly in 1996-97. Therefore, there is a need to reassess the entire system and to strengthen it (Agosin and Ffrench-Davis, in this volume). Nonetheless, portfolio capital and interest-arbitraging inflows have been modest in comparison with those of other countries in the region. During the 1990s, investment rates have risen from 22 per cent of GDP to about 28 per cent.

Mexico, on the other hand, beginning in the late 1980s, completely liberalized the capital account of its balance of payments. Portfolio inflows and credits in foreign exchange to Mexican banks bulged. Total capital inflows reached about 8 per cent of GDP in 1992 and 1993, of which over two thirds were portfolio inflows. International investment banks "discovered" Mexican assets (mostly stocks, money market instruments, and government debt) and rushed to take positions in them. At the same time, a poorly regulated banking system borrowed heavily in international capital markets to onlend to real estate developers and speculators in financial assets. Domestic interest rates in Mexico were much higher than in the United States, and the nominal exchange rate was in effect fixed, with generalized expectations that the peso would appreciate in real terms (Gurría, 1995). These expectations were indeed validated by the market, and there also ensued very sharp real estate and stock market booms. The appreciation of the exchange rate made real investments in the tradable sectors less attractive and, at the same time, increased real wages, fueling a consumption boom. The latter was also stoked by the wealth effects of higher stock market valuations and increases in the prices of real estate. As a consequence, investment stagnated and domestic saving was "crowded out" by foreign saving.

Of course, crowding out is not an inevitable outcome of capital inflows. It happens when capital inflow is too large, it comes in at a too fast a pace to be productively absorbed by the domestic economy, and it takes forms which are bound to divert resources to consumption rather than increase investment.

The end of the Mexican story is well-known and is a graphic illustration of the behavior of international financial markets: once sentiment began to change, foreign and domestic financial capital rushed for the door, causing a steep reversal in Mexico's fortunes and in the financial markets' perceptions of what were in fact the economy's "fundamentals". This in fact means that there exist multiple "equilibria": one with large inflows and another with large outflows.

Calvo and Mendoza's (1996) model for analyzing the Mexican peso crisis is broadly congruent with Eatwell's perception: they claim that, since the assets of firms from a particular developing countries are normally a small proportion of international investors' portfolios, it may not pay for them to go to the trouble of obtaining information about the country and its companies, which is, of course, very costly. Therefore, they tend to go on "signals". In the case of Mexico, the "signals" encouraging inflows were the pro-market reforms undertaken in the second half of the 1980s and the prospect that Mexico would join the United States and Canada in NAFTA. On the other hand, the signals of 1993-1994 leading to a reversal in the direction of financial flows were the notions that current account deficits had become "unsustainable" and that the exchange rate had appreciated "excessively". Of course, the large current account deficits and the appreciating exchange rate had been partly a consequence of the exogenous (and collective) behaviour of foreign investors in the first place. As Eatwell rightly points out, this is a clear example of investors' herding behavior: very large inflows of financial capital give way to very large outflows.

The price that Mexico paid for financial openness was very high: there was a contraction of 7 per cent in Mexico's GDP in 1995, and inflation soared to over 50 per cent. The volatile and self-fulfilling behavior of foreign portfolio capital (and also of domestic capital with the option of investing abroad) provides a vivid lesson of the perils of unregulated liberalization of the capital account.

There can be little doubt that a capital-scarce country stands to gain if it can attract stable foreign capital to its economy. But foreign capital is not a single entity. Different types of capital behave very differently and have very different time horizons. Foreign direct investors usually think in terms of very long-term strategies. Financial investors, on the other hand, have short horizons and a preference for instruments that provide a quick exit option. It is imperative that policy makers distinguish between different types of investors and design policies that take these crucial differences into account, rather than buying wholesale the notion that liberalization, in all circumstances, is always the alternative that maximizes welfare and growth.

2. Emerging East and South-East Asia: the new victim of financial instability

During 1995 the Tequila effects on Asia were negligible. This was so even in economies with large deficits on current account like Malaysia and Thailand. As a consequence, the year 1996 saw many outstanding researchers and observers asserting that those deficits were not relevant if investment ratios and growth were high. Thailand was one of those cases. By late 1996, a staff report published by the IMF praised Thailand as a "road to sustained growth" (Kochhar et al, 1996).

A few Asian countries had rather free capital flows, but several others had regulated capital inflows and exchange markets successfully for long periods (see Helleiner, 1997; and the cases of Malaysia, Indonesia and Thailand, in Sachs, Tornell and Velasco, 1996b); and many had carried out effective second level sterilization policies (Reisen, 1993). Growth was actually sustained and extremely high. In 1980-95 GDP yearly growth averaged between 6 and 8 per cent in the Republic of Korea, Indonesia, Malaysia and Thailand; the investment ratio exceeded 33 per cent, with domestic savings ratios close to that notable level; inflation was low, in the 5 per cent range, and fiscal budgets were generally balanced. In the meantime, the average annual GDP growth in Latin America was 2 per cent, and the investment ratio fluctuated around 20 per cent.

What explains the sudden inverted comparative perceptions of Asia and Latin America in 1997?

First, what works for some time might see its efficacy reduced after a while. A relevant feature relates to exports. In fact, after a couple of successful decades, the exports of several Asian economies were recently experiencing problems. What had been until then products with a notably dynamic demand appeared to have been reaching "maturity", facing tightening markets (Sachs, 1997).

Second, even if exports are well-behaved, a disequilibrium can emerge if imports experience a boom. In both Korea and Thailand imports rose sharply in 1995-96. This boom was related to expanded aggregate demand and to cheaper imports (due to some import liberalization together with exchange-rate appreciation, a recent "Latinamericanization" of some Asian economies). Rising capital inflows allowed for that inconsistency to prevail until the emergence of the crisis.

Third, good sustained policies can be reversed under exogenous pressures. The strong drive toward financial liberalization prevailing in the world today has also permeated Asia. Actually, the deficit on current account increased substantially in Thailand since 1995; but also Korea experienced a shift from a negligible deficit in 1992-94 to a 5 per cent deficit in 1996. These external deficits were not led by public deficits and did not imply loses of international reserves. Neither were they due to a exogenous increases of private expenditure. On the contrary, private expenditure rose because of capital inflows. In Korea, Indonesia, Malaysia, and Thailand international reserves were accumulating persistently between 1992 and early 1997, fed by capital inflows in excess of the deficits on current account, pressing local authorities to purchase foreign currency. Reserves more than doubled in those countries in that period. It was a phenomenon led by capital inflows, which sustained moderately appreciating exchange rates and a strongly increased aggregate demand (with a significant enlargement of the deficit in current account by 1996 in Korea, Indonesia and Thailand). The additional financing was mostly short-term (Sachs, 1997). In the particular case of Thailand, in each of the years 1994-96 short-term capital inflows mounted to 7-10 per cent of GDP (IMF, 1998). Inflows contributed to a domestic lending boom, with bubbles in real estate prices. Serious weaknesses in prudential supervision, not so relevant in the previously repressed domestic capital markets, became evident, and a significant reinforcing factor in the macroeconomic disequilibrium that surfaced in 1997. This is a mistake that policymakers in these countries shared with those spearheading financial reforms in Chile in the 1970s and in Mexico in the 1990s.

3. Lessons for Latin America

Optimism regarding Latin America returned to the international financial markets in 1996-97. Net capital inflows climbed to their pre-crisis levels. Their composition has improved, with a larger share of FDI. The decline in GDP in various Latin American countries was reversed. In fact, a dynamic growth for the region as a whole is observed since mid-1996, with GDP rising 5.3 per cent in 1997.

Nevertheless, it should be noted that GDP increases comprise a large share of recovery; that is, effective GDP has been moving toward the production frontier. However, the frontier is moving outward slowly, because productive investment is still low, while real exchange rates are returning to an appreciation path. Consequently, as long as productive investment does not increase substantially (and it is still notably lower than in East and South-East Asia), that rate of growth is not sustainable in 1998. Additionally, the Asian crisis will worsen the terms of trade and the access to markets of Latin American exports. Then the region will experience a new adjustment, though now without a crisis. The future, however, will depend on whether the region's policymakers have learnt the lesson. There are very mixed signals that this is in fact the case.

The recovery of GDP in Argentina and Mexico has been particularly vigorous; however, after the nearly 6 to 7 per cent decline in both countries following the Tequila Effect,[2] there was a large gap between effective GDP and produc-

[2] There was a drop of 6.6 per cent in Mexico in 1995 in comparison to 1994, and of 6 per cent in Argentina between April 1995 and March 1996, in comparison with the preceding twelve months.

tive capacity. This enabled a significant reactivation to take place. Nevertheless, in both countries it took until 1997 for GDP per capita to approach the levels achieved before the Tequila Effect, while average wages were still lower even then. Rather than the result of policies adopted in 1995-96, this is the cost of the policies implemented before the crisis. The following lessons can be derived from recent policies and outcomes.

Level, Composition and Sustainable Uses of Flows

It is important to ensure that the inflow of funds is directed to productive investment. Allowing too much to drain off into investments on the stock exchange and consumption of imported goods will create bubbles and imbalances that would be unsustainable (Ffrench-Davis and Reisen, 1998). Additionally, rapidly rising stocks of external financial liabilities tend to be increasingly dangerous.

Opening up the capital account indiscriminately can be very detrimental to productive development and to the welfare of the majority of people, inasmuch as externalities and other imperfections of international capital markets give rise to frequent cycles of abundance and shortage of external financing. The instability of exchange rates and of macroeconomic indicators that is usually associated with unrestricted openness is always very costly in terms of production and equity. Effective, efficient regulation is possible; Chile proved this from 1991 onwards, and Colombia did so during the 1970s as well as in recent years (Urrutia, 1996; Devlin, Ffrench-Davis and Griffith-Jones, 1995).

Avoiding Outlier Prices and Ratios

Governments must ensure that capital flows do not generate atypical (outlier) prices or significant distortions of basic macroeconomic indicators, such as interest rates and real exchange rates, the composition of expenditure in terms of consumption and investment, and the production of tradable goods.

The fact that exports are growing vigorously does not justify the assumption that improvements in productivity will offset a lag in the exchange rate, as economic authorities have repeatedly claimed. If imports are growing steadily, and at a faster rate than exports, there is reason to be concerned, and corrective measures should be taken in time to prevent an unsustainable accumulation of external liabilities.

Governments should not use capital inflows as the main tool for achieving a narrow or extreme objective related to a single domestic economic variable, especially over a long period of time; a case in point is the effort to halt inflation by appreciating the exchange rate. This tends to throw other major variables off balance, thus affecting the very instrument being used, i.e., the exchange rate and capital flows, and weakening the basis for sustainable growth (Fanelli and Frenkel, 1994; Ffrench-Davis, 1996). In particular, it is very risky to discard implementing an exchange rate policy by remaining bound to a fixed nominal rate. The methods to regulate exchange rate can be extremely diverse; several of them involve some form of an exchange-rate crawling-band, with some type of intramarginal intervention (Williamson, 1996).

Controls, of whatever type they may be, are often seen as inefficient and easy to get around, considering the increasing sophistication of transactions on the capital market. Some controls on capital can indeed be clumsy and costly, as was the case in Venezuela in 1994-95. However, as Williamson (1993) points out, statements about the ineffectiveness of controls on capital flows are highly exaggerated. Regulation of capital flows tends to be effective as long as it is oriented to the predominance of mid-term forces over short-term fluctuations in domestic markets. The regulation will indeed have a microeconomic cost, but this cost should be balanced against the social benefits in terms of macroeconomic stability, investment and growth (Zahler, 1996).

The recent experience of Latin America has shown dramatically that allowing the market, dominated by agents with short horizons, to determine the volume and composition of capital flows can have a devastating cost for the recipient country.

Consistent Sequencing

With regard to the sequence of reforms, it is generally agreed that the opening up of the capital account was premature and should have been postponed until other major reforms had been consolidated and new equilibrium prices had been established. The lesson to be learned from this experience is that during structural adjustment, open capital accounts (especially when international financing is abundant) can attract excessive capital flows and have destabilizing macroeconomic and sectoral effects (Edwards, 1984; McKinnon, 1992).

In the first place, in the particular case of Latin America, many countries introduced deep trade reforms in the 1990s *pari passu* with exchange rate appreciation. Second, if productive investment capacity reacts slowly and/or with a lag and domestic financial markets remain incomplete and poorly supervised, additional external resources cannot be absorbed efficiently in the domestic economy, and thus they threaten the future stability of the flows themselves. In the third place, fiscal parameters need to be consolidated, since in the absence of a sound tax base and flexible fiscal mechanisms, the authorities will have to depend excessively on monetary policy to regulate aggregate demand. Finally, since part of the aggregate demand generated by capital flows is inevitably spent on non-tradable goods, when actual demand comes close to the production frontier, the relative price of non-tradables tends to rise. This in turn is reflected in a higher current account deficit. A real revaluation of the currency can obviously distort the allocation of resources and investment, seriously weakening the structural mid-term objective of penetrating external markets with new exports (ECLAC, 1995; World Bank, 1997).

Flexible Selective Regulation

It is not wise to make an inflexible commitment to keeping the capital account indiscriminately open, particularly in light of the crucial importance of maintaining macroeconomic stability, and the disproportionate volume of the international capital markets compared with the small size of the markets of Latin American countries. There are serious shortcomings in both domestic and international financial markets. As long as market movements depend to a significant extent on short-term transactions and domestic securities markets remain shallow, there will be a risk of great instability in this new modality of linkages with the international economy. In fact, Mexico's and Thailand's recent critical experiences attest to the wisdom of discouraging large financial inflows and increasing accumulation of short-term external liabilities. There is growing evidence that the greater the instability of flows (or deviation from the trend), the lesser the share directed to productive investment (see Uthoff and Titelman, 1998).

It should be stressed that, post Mexico 94, institutions such as the International Monetary Fund (IMF, 1995 and 1997); the Bank for International Settlements (BIS, 1995); and, recently, the World Bank (1997), have recognized the advisability of taking steps to discourage excessive inflows of short-term capital, as part of an efficient macroeconomic management of capital flows. Also, the Presidents of the member countries of the Group of Rio, have expressed their concern regarding the volatility of capital flows. On the other hand, following arduous negotiations on a trade and financial agreement between Canada and Chile, it was agreed that Chile could maintain regulations on capital inflows with a broad range of flexibility. This is a precedent of great significance for achieving sustainable stability and growth.

Understanding better the working of domestic and international financial markets is at the core of the future of the world economy. More pragmatism and more systematic efforts should be at work.

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