Why Free Capital Mobility may be Hazardous to Your Health: Lessons from the Latest Financial Crisis

By

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Since I am unable to return from Chile in time for this Conference, Marty has asked me to put on video my views on Free Capital Mobility (FCM), i.e. on full-blooded capital account convertibility, as expressed originally in my May 1998 **Foreign Affairs** article.

Presumably, this is because the article has attracted an inordinate amount of attention. I am told by the **Foreign Affairs** editors, who provocatively titled it **The Capital Myth**, that it is possibly the most reprinted and translated economics article in their magazine in recent years. *I also notice that, in the latest issue, almost 8 months after mine appeared, the IMF has gotten its External Publicity Director, Shailen Anjaraia, to write a rather feeble 2-page riposte: a sure sign that the IMF regards the article as particularly potent in view of its being cited by all sorts of G-somethings that are part of the IMF's clients and patrons!*

I guess my views concerning the acute problems raised by FCM, and the contrast I raised with Free Trade (FT) which is free from these problems, are not particularly bizarre or off the curve. Indeed, I have held these "asymmetric" views about FCM and FT for as long as I remember. Indeed, they were expressed, by reference to Chilean experience, in the Report on India's Economic Reforms that I and T.N.Srinivasan prepared for the reformist Indian Finance Minister in 1992-93. But somehow, the public expects that if you are for one sort of Globalization, you must logically be for another: that Free Trade, Free DFI, Free Capital Flows, Free Immigration, Free Love, Free…whatever should go together! Well, they are wrong.

But this **unwarranted link** between FT and FCM is a major source of problems for FT today, as I discover in increasing numbers of debates with FT's opponents such as Ralph Nader just a few weeks ago at Cornell: the sins of FCM are visited on the virtues of FT. *Even Dani Rodrik, one of us, in a recent TNR essay, seems to draw sustenance illogically from the social consequences of the financial crisis to condemn the "myths and half truths" of FT and for an alleged disregard of the social consequences of FT (which is another matter altogether).* And, so FCM has imperiled the cause of FT in an insidious but potent fashion.

So, the issue of FCM is of great importance. But if I argue that FT and FCM are asymmetric, it does not follow that I am all for capital controls either. I shall take the opportunity provided by Marty therefore to recap and explain my position through a succession of **Six Propositions** (which I spell out somewhat fully).

Proposition 1: The case for FT is different from the case for FCM: there are similarities but there are also important differences. Specifically, capital flows are subject to what Kindleberger has famously called Panics, Manias and Crashes. In theoretical terms, we would say that destabilizing speculation can, and does, break out where the speculators can emerge unscathed even when they are betting against fundamentals because these fundamentals shift as a result of the speculation, validating the speculation. *[The original Friedman argument that destabilizing speculation would punish the speculators is therefore not correct. The first known argument to that effect, I believe, is by Triffin, then by Aliber, and later the argument has been formalized by a number of theorists, principally Maurice Obstfeld, who naturally show that multiple equilibria can obtain in this game.]*

No one of sound mind can seriously sustain the notion that either trade in goods and services leads to such problems or we have the macroeconomic expertise, indeed the alchemy, to eliminate this important, inherent downside of free capital flows.

Proposition 2: Therefore, this downside of FCM must be put against the upside of FCM. The upside consists, of course, of two important and well-known arguments: (1) freedom to buy and sell, as also to move capital, is a value in itself *(but, of course, it does not follow that, like the freedom to shout "fire", it must necessarily be left unregulated and unconstrained if the consequences are immensely harmful to society at large*); and (2) any time you free up a market, there is a presumption of deadweight gain in efficiency.

But two qualifiers must be added. First, Richard Cooper has argued that , drawing on the celebrated Brecher-Alejandro argument, free capital flows in the presence of trade distortions can be immiserizing (or, at least, would have less than apparent value). There are, of course, still many tariffs in place around the world. So, Cooper's caveat certainly has some relevance. I

would draw from it the policy judgment, not that FCM is bad, but that it must be preceded by substantial trade openness. I return to this later, arguing that it is better to have many developing countries not yet on FCM to concentrate their energies instead on pushing further towards FT.

Second, as I said in the May 1998 essay, the gains to developing countries from capital inflow, and more, can be obtained by encouraging the inflow of DFI which also brings in skills and technology, and is pretty much regarded today, and properly so, as a source of mutual advantage, like FT. DFI can be attracted by granting convertibility to the firm's earnings and capital; this is a much restricted and targeted form of capital account convertibility which does not extend to the ability of nationals and non-nationals to take capital out of a country in any magnitude, or letting firms and banks borrow short-term capital freely, precipitating and intensifying crises. True, if you had the latter, i.e. full convertibility, perhaps there might be more DFI; I doubt, however, that this loss is large.

Proposition 3: The gains from FCM, measured at "crisis-free" value, must in any event be set against the expected value of losses during a crisis. The latter obviously reflects the probability of a crisis setting in and the expected value of the losses during the crisis.

Proposition 4: (1) What then can we say about the "crisis-free" gains? Here, I am afraid that we have really do not have, to my knowledge, any studies that suggest that the gains from FCM are "mammoth" as Bradford deLong has argued. I am not suggesting that capital flows, per se, could not have a beneficial effect, ceteris paribus. But even this likely outcome has to be discounted by the fact that inflowing capital may well be put to bad use: a possibility that may be linked to the fact that short-term inflows tend to increase sharply in the presence of unsustainable asset price booms.

Also, the question before us is really not whether capital inflows are productive, but rather whether FCM, i.e. capital account convertibility, is associated with rapid growth and prosperity. Here, surely the answer is even tougher to provide. We have had hugely successful economic growth in China and Japan, for instance, without FCM. *Dani Rodrik has bravely tried to look at the empirical issue by using multi-country regressions and finds no relationship between capital account convertibility and growth. While I must confess to a prejudice that I find*

this kind of analysis too unsubtle to have much value --- I talk about "endless" regressions whereas Bob Solow is more frontal and calls them "mindless" regressions --- , it may nonetheless be used as one more reason to look some of the more extravagant claims regarding the gains from FCM in the eye.

(2) Reinforcing this skepticism about "mammoth" gains from FCM, we would have to reckon also with the fact that, as the latest Asian crisis demonstrates, the probability of being hit by a crisis (once you have FCM and hence the possibility of excessive short-term exposure and associated possibility of herd-behaviour-driven panics for instance) is not exactly "low".

Until we have had the new Bretton Woods conference everyone is talking about, and we have decided what is the new international architecture that we are going to have, it is not even clear that much can be done to effectively reduce the probability of being hit by the crises and to increase the efficacy of dealing with them adequately when they arise. The latest IMF/World Bank meetings revealed how much we need to know what the right solutions are and (sadly) how little we know what they are!

Proposition 5: Add to all this the fact that the IMF can, and indeed did in the current Asian crisis, get its conditionality badly wrong as well. I am persuaded by Sachs & Radelet's arguments, and by a recent brilliant essay by Max Corden, that the IMF should not have gone in for deflationary policies but should have instead undertaken a Keynesian-style reflationary policy to offset the initial and induced deflationary effect of the capital outflow. *True, one can make several arguments for what the IMF did; and it is inherent in the macroeconomic game that the assumptions one makes about responses of agents to policies may turn out to be either wrongly signed or badly off on the parameters. But the fact is that the IMF did get things wrong, according to even impartial observers who have nothing against the IMF and do not proceed on the assumption that whatever the IMF does, the opposite must be the right policy.*

So, when the crisis hits, you are not even sure that it will not be compounded, instead of being eased, by those whose job it is to assist you! So, that increases yet further the likelihood of significant costs from the crisis when it hits you.

But these are only the economic and social disruptions that can get you politically. What happens when the IMF starts telling you to change your "structural" policies which have little to do with the crisis at hand, or else? When you look at the conditionalities imposed on Indonesia and South Korea, for instance, you cannot but raise this question. Marty Feldstein, in his **Foreign Affairs** article, also greatly influential, raised this question trenchantly. And I agree with his view that this was an unwelcome development. Besides, how does one know that the IMF's judgments about structure were correct, being given to countries whose track record on growth has been so substantial that it has been described correctly as a "miracle*"! It needed chutzpah, or deep concession to Washington's longstanding demands to remake Asia in its own image, to ask for these kinds of changes. As Marty has noted, these are questions to be decided by sovereign nations*. In short, to the immediate economic costs of wrongheaded early IMF conditionality, we must add the political costs of unjustified loss of sovereignty and even the longterm costs of possibly ill-advised and politically-driven demands for changed policies in place of ones that these afflicted nations preferred and may well have aided in producing their high growth rates.

In addition, I must note specifically, as many have, that the IMF's and Treasury's continuous hammering of the theme that these countries were characterised by "crony capitalism", "corruption", "inefficient" policies, and every other sin in the Book of Virtue, to the exclusion of the role played by what I have called the Wall Street-Treasury Complex (in a non-conspiratorial sense), was a self-serving analysis. This only aggravated the panic that started and fueled the crisis; it was thus not merely wrongheaded but also accentuated the problems both for the afflicted countries and, in turn, for the IMF itself.

Proposition 6: So, if we are to draw any lessons concerning FCM at the present time, I would make the following two observations:

First, there are many developing countries which are still not on FCM. The IMF, and indeed the Wall Street-Treasury Complex, had been pushing aggressively for greater shift to FCM. True, the IMF's splendid economists cannot have been unaware of the reasons to go easy on this; but the political pressures and the euphoria were huge enough to make even the IMF drop its guard de facto. I believe that there is now more prudence on this question.

So, for these countries, for whom the question is not one of adopting capital controls but of dropping them, I would say: "Cease and desist from moving rapidly to FCM until you have gained political stability, economic prosperity and substantial macroeconomic expertise --- and not just "transparency" and better banking supervision. Concentrate instead on freeing external trade barriers and implementing internal reforms such as privatization."

Second, for the few developing countries that had embraced FCM more or less, and which have run into the current and the earlier crises, the question is rather different: should they, like Malaysia, make a 180 degree turn and abandon FCM for a slew of capital controls? *Here, I incline to an asymmetric answer from that to the preceding question. Using an analogy, I would say that if you have joined the Mafia, you do not go up to Mr.Gambino and just tell him that you are leaving; if you do, you will leave in a coffin. What you do instead is to call up the FBI, get into the witness protection program, and so on. Similarly,* the countries already in the FCM game must exercise caution instead of making a u-turn precipitously to capital controls. More specifically, I would distinguish among 3 groups of countries.

(i) Once you have been on FCM more or less, and you experience reversal of capital inflow of the order that added up to over 10% of GNP for the five afflicted Asian countries, the main problem surely has to be: how do you get some or most of this capital back in order to ease the inevitably serious problems caused by this huge loss of resources. *[If I recall correctly, the income loss imposed by the oil price increases of 1971 and 1973 on OECD countries was of the order of 3% of GNP and was sufficient to unsettle these advanced countries' macroeconomics almost through the 1970s.]*

So, restoring confidence is essential. Capital controls, especially in a sharp turn, surely cannot provide, and will only undermine further, that confidence in my view. True, as Krugman has reminded the advocates of such a policy, you can lower interest rates with controls and then revive the economy. But, if the diffidence has worsened, who will borrow to invest? I therefore think that Malaysia's option should have been to stay the course and to work with a chastened IMF which has reversed course and begun to back reflationary policies in the region. And I would advocate the same for all those who are already in the game of FCM in a significant degree and have gotten into trouble.

(ii) For the countries on FCM that have fortunately not gotten into trouble because they were prudential and watched their short-term debt exposure <u>and</u> regulated it Chilean style as called for, my advice : stay the course and continue doing more of the same.

(iii) And for those countries on FCM that have unwittingly managed to avoid getting short-term flows in any significant degree, the best policy advice is to be prudent for the future: introduce monitoring and review of future inflows, while keeping Chilean style control mechanisms in place for use <u>as necessary</u>.