Revisiting cross-border capital flows

Funding current account deficits primarily through debt and portfolio flows is potentially destabilising for both developed and developing countries, says ***Alok Sheel***

Classical economics had made a strong case for the welfare effects of both free trade (based on the principle of comparative advantage) and free flow of capital (based on the assumption that capital would flow from low-return, capital-surplus countries to high-return, capital-deficit countries). Unsurprisingly, till recently, the IMF's policy advisory to developing countries was to gradually move to full convertibility on the capital account, with some caveats on pre-conditions and sequencing added in wake of the Latin American experience with capital flows.

This advisory was gradually abandoned, especially following the east Asian crisis. A broad consensus appeared to be emerging that limited capital controls in some form or the other would be imposed even by developed countries, especially in the area of foreign investment. While the argument in favour of free trade remains robust, with some notable exceptions, the current global financial crisis has *inter alia*, reopened the debate on the welfare effects of capital flows and on a long-standing proposal to impose a 'Tobin tax' on cross-border capital flows.

Lessons from economic history should, however, caution us against knee-jerk reactions that impose restrictions on free markets, as there is usually a developmental price to be paid. The case of financial repression comes easily to mind. At the very least, we need to be certain whether the villain of the piece in the current crisis is regulation, imbalances, excessive leverage or capital flows. According to received wisdom, developing countries have a shortage of both savings and investment. Savings are low because per capita incomes are low. By definition, those below the poverty line have no savings whatsoever. Capital inflows from developed countries, where returns from capital are lower, are expected to partly plug these twin gaps.

The flipside of the savings-investment gap is the current account deficit, financed through a surplus on the capital account. A current account surplus is considered a bad thing for developing countries as this is tantamount to decapitalisation of the kind occurred in the aftermath of the debt crisis in Latin America.

Ideally, developing countries should run current account deficits at levels that can be reasonably expected to be funded through capital inflows on a sustainable basis. Generally speaking, higher the proportion of FDI in total capital flows, the higher the sustainable level of current account deficit, since an excessive build up of external debt exposes developing countries to ratings downgrade and/or sudden stops. By this yardstick, while portfolio flows are officially classified as debt, their macroeconomic impact is closer to short-term external debt. The significant difference between the two is that in the event of sudden stops short-term borrowers incur exchange rate losses, while portfolio investors incur both exchange rate and capital losses.

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Globalisation of production chains and two-way volatile capital flows spawned a new export-led model of growth emanating in some east Asian countries, and especially China, that has punched conceptual holes into the two-gap model that was (implicitly) based primarily on domestic demand. It was essentially a closed economy model with capital flows as an autonomous external variable.

It now appears that developing countries may combine rapid growth with a surplus of savings over investment, despite low levels of per capita income, exporting the surplus savings by running current account surpluses. This is possible by relying on external demand in high-income countries as the engine of growth.

However, if the capital account were fully convertible and free, there would be an inherent tendency for the current account to move back towards balance through exchange rate adjustments. In these circumstances, the only way to sustain an export-led model of growth is to:

- maintain an open and fully convertible capital account in deficit countries, and a controlled capital account in surplus countries with central bank interventions to prevent exchange rate appreciation.
- use hard currency reserves built up through intervention in foreign currency markets in surplus countries to sustain consumption — household and/or government — in high income deficit countries.

Funding current account deficits primarily through debt (including portfolio flows) is potentially destabilising for both developed and developing countries on account of the risk of sudden stops and financial bubbles based on excessive leverage. The current global financial crisis would not have occurred had the US current account deficit been financed primarily through green-field FDI rather than debt flows. In that event, the external imbalance would have been primarily on account of excess investment rather than excess consumption. If the major deficit country is also the issuer of the global reserve currency, destabilisation is likely to be through financial bubbles rather than sudden stops on account of the flight to quality.

In a sense, unrestricted cross-border capital flows are to the advantage of the country that mint the global reserve currency as they are supportive of its monetary and fiscal policies. But are they supportive of sustainable growth in developing countries? Quite apart from academic studies that have shown that there is no robust empirical link between growth and capital flows in developing countries, recent events have shown that capital flows other than green-field FDI can be destabilising. Since cross-border capital flows respond to monetary and fiscal policies of the reserve currency issuing country, these are available in abundance when needed least (such as when monetary policy in the reserve currency country is loose, and fiscal policy is tight, and there is a surge in capital flows to emerging markets to increase yields) and there is flow away from developing countries when capital is needed most (such as when monetary policy is tight and fiscal policy is loose with high treasury yields, leading to a flight to quality).

In these circumstances what should be the stance towards capital flows by rapidly growing developing countries that do not consciously follow an export-led model of growth, and are neutral between production for domestic and export markets?

One, running current account deficits is a good thing as long as foreign savings are invested, since this can, *ceteris paribus*, raise rates of economic growth. Such deficits should be sustainable over the medium to long term. Two, since FDI goes directly into investment, these should be encouraged without limits and restrictions, some strategic, brown-field areas excepted. Three, external debt, especially the more volatile short-term component, needs to be limited to productive investment or variable capital to finance production. If external debt tends to imprudent levels, it should be further restricted to financing the foreign exchange component of investment and variable capital. Four, portfolio flows need not be actively encouraged beyond what is necessary to fund the current account deficit. Such flows can be volatile, can inflate asset prices, lead to sudden, sharp appreciation of the currency, and queer the pitch for monetary policy. In these circumstances central bank intervention to stabilise the exchange rate/smoothen the curve is eminently justified to protect the real economy from violent perturbations in financial markets. Consequential hard currency reserve build up may make management of monetary policy difficult, but can also protect the real economy in the event of sudden stops and also sustain higher current account deficits, and therefore higher growth over the medium term.

In essence, while capital flows should be leveraged by developing countries to elevate and sustain growth, they also need to be prudently managed.

The author is a civil servant. Views expressed are personal.