

**CAPITAL ACCOUNT LIBERALIZATION, FREE LONG-TERM
CAPITAL FLOWS, FINANCIAL CRISES AND ECONOMIC
DEVELOPMENT**

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Abstract

The first part of this paper examines the theoretical and empirical case for full capital account liberalisation in developing countries(DCs) and finds it unconvincing. Indeed, analysis and evidence presented here point to a compelling case against it. The second part considers the liberalisation of only the long-term capital account, particularly FDI - a form of in-flow favoured by most economists. This paper, however, argues that even FDI, if unregulated, may do more harm than good. It is suggested that DCs should, therefore, resist the new advanced country proposals for a multilateral agreement on FDI.

JEL Codes: F2, F3

Keywords: Capital account liberalisation, FDI

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Capital Account Liberalisation, Free Long-Term Capital Flows, Financial Crises and Economic Development

1. Introduction: Main issues and the international policy context

In examining the relationship between financial liberalisation, crises and long-term economic development, one of the most controversial issues is that of capital account liberalisation. This is largely because it is the area where there is the greatest disconnection between economic theory and actual events in the real world. Neoclassical theory suggests that the flows of external capital should be equilibrating and help smooth a country's consumption or production paths. However, in the real world, exactly the opposite appears to happen. Capital account liberalisation has been associated with serious economic and financial crises in Asia and Latin America in the 1990s. The proponents of neo-classical theory argue that the case for free capital flows is no different from that for free trade - the former could simply be regarded as a form of inter-temporal trade. The first part of the paper (sections II-IV) will address this central controversy in relation to developing countries and specifically ask the following questions:

- Are trade liberalisation and free capital flows analogous in increasing social welfare? What are the conditions necessary to maximise their prospective benefits?
- What is the precise nature of the relationship between capital account liberalisation and economic crises?
- Why do such crises occur far more in developing than in advanced countries?
- Do free capital flows lead to faster long term economic growth which may compensate for the crisis and the economic instability associated with capital account liberalisation?

In analysing capital account liberalisation it is customary to distinguish between short-term (e.g., portfolio flows and short-term bank loans) and long-term capital flows (e.g. FDI). In the light of the recent deep economic and financial crises in Asia, Latin America and Russia many (but by no means all) economists will today accept that free short-term capital flows could have seriously adverse consequences for developing countries, as these flows are often volatile subject to surges and sudden withdrawals. However, long-term capital flows, particularly FDI, are regarded as much more stable and therefore for this and other reasons are thought to have a positive influence on long-term

economic development. It is therefore suggested that developing countries, in liberalising their capital account, may wish in the short- to medium-term to liberalise only long-term capital flows such as FDI, while still controlling, partially or wholly, short-term flows.

Even Joseph Stiglitz who has been a fierce critic of precipitate capital account liberalisation in developing countries appears to favour free FDI flows. Thus Stiglitz (2000) finds striking "the zeal with which the International Monetary Fund (IMF) had requested an extension of its mandate to include capital market liberalisation a short two years earlier at the Annual Meetings in Hong Kong. It should have been clear then, and it is certainly clear now, that the position was maintained either as a matter of ideology or of special interests, and not on the basis of careful analysis of theory, historical experience or a wealth of econometric studies. Indeed, it has become increasingly clear that there is not only no case for capital market liberalisation, but that there is a fairly compelling case against full liberalisation" (page 1076). Stiglitz, however, makes it clear that his general strictures against capital account liberalisation are primarily directed against short-term speculative flows. He writes, "the argument for foreign direct investment, for instance, is compelling. Such investment brings with it not only resources, but technology, access to markets, and (hopefully) valuable training, an improvement in human capital. Foreign direct investment is also not as volatile - and therefore as disruptive - as the short-term flows that can rush into a country and, just as precipitously, rush out".(page 1076).

This paper will take major issue, with the orthodox laissez faire position (see for example Summers, 2000; Fischer, 2000), of the desirability of speedy capital account liberalisation in developing countries. It will however also part company with Stiglitz in important respects. It will be argued here that although Stiglitz is right in suggesting that free-trade in capital is not the same thing as free trade in goods, he implicitly assigns too much virtue to the latter. This argument will be made here more in global economic terms rather than in those of the traditional concepts, such as infant industry protection. It will further be suggested that not only do developing countries need controls against short-term capital flows for many of the reasons Stiglitz puts forward, but they also require controls against free FDI flows. The second part (Section V-VIII of the paper) would argue that free movements of FDI would contribute to financial fragility in developing economies and also will not serve the cause of economic development in a number of other ways.

These issues of capital account liberalisation are of course not only of academic interest, but clearly of serious policy concern for developing countries. There is however, also an important international context to the policy debate on this subject. The goal of capital account liberalisation for all countries, together with an orderly and fast progress towards it, has been at the heart of the proposals by G7 countries for the New International Financial Architecture (NIFA). Similarly, the European Union and Japan have raised the question of the free movements of FDI as an important subject for study and eventual negotiations at the WTO. There is already a large literature on the NIFA¹, while the advanced countries proposal for the free movement of FDI has not received as much attention. This paper will attempt to redress this imbalance by focusing the second half of the paper on FDI flows, specifically on the proposed new multilateral agreement on such flows.

2. Free trade versus free capital movements: Are they analogous²?

II.1 Free Trade and Trade Openness: Analytical Considerations

The case for free trade is best put in terms of the two fundamental theorems of welfare economics. According to the first welfare theorem, a competitive equilibrium in the absence of externalities and non-satiation constitutes a Pareto optimum. The second theorem, which is more relevant for our purposes, states that any Pareto optimum can be realised as a competitive equilibrium in the presence of all-around convexity, provided suitable lump-sum transfers can be arranged among the participants. These are demanding assumptions and are not easily met in the real world. Nevertheless, neo-classical economists suggest that such considerations do not destroy the case for trade openness but only change the nature of the argument. Thus Krugman (1987) concludes his classic defence of free trade in terms of modern theory as follows: "this is not the argument that free trade is optimal because markets are efficient. Instead it is a sadder but wiser argument for free trade as a rule of thumb in a world whose polities are as imperfect as its markets."

As suggested in Chakravarty and Singh (1988), there is, however, a more robust economic case for trade openness (rather than free trade) which would explicitly take into account increasing returns to scale and imperfect competition. It would also stress the role of learning through economic interactions with the rest of the world. However, it would need to assume that the level of aggregate demand in the world and national economies was adequate to provide continuous full utilisation of resources and full employment. Within this kind of setting, trade

openness can be a source of great advantage for an economy for any one of the following reasons:

- (a) it may enable a country to concentrate its relatively specialised resources in areas of production where the world demand is highly income and price elastic;
- (b) it may lead to diffusion of knowledge of a nature which can lead to considerable upgradation of the quality of local factors of production;
- (c) it may lead to sufficient competitive pressure to eliminate X-inefficiency;
- (d) trade may lead to changes in the distribution of income which can lead to a greater share of accumulation in national income;
- (e) trade may facilitate what Schumpeter stressed so much: an accelerated process of creative destruction.

In general, trade openness works positively if the phenomenon of "learning" from contacts with the rest of the world are institutionalised through suitable adaptations on the policy side involving appropriate government interventions which make the domestic economy more responsive to change. This is a main lesson that emerges from the outstanding industrial success of East Asian economies during the second half of the 20th century.³ Countries such as Japan and Korea established comprehensive technology and industrial policies to institutionalise such learning. At a theoretical level, however, it must be stressed that *learning over time* is a more relevant paradigm for developmental gains from trade than the neoclassical story that emphasises the exploitation of arbitrage opportunities. [See Passinetti (1981) for a fuller discussion of the learning approach to this issue.]

To sum up, while the classical and neoclassical arguments for "free trade" suffer from serious conceptual and operational difficulties, there are indeed substantive benefits from "trade openness", which are more robust than the traditional neoclassical theory suggests. However, such benefits can be realised only in a world of full employment coupled with an appropriate set of domestic policies which go considerably beyond the limits of commercial policy as traditionally defined.

II.2 The Case for Capital Account Liberalisation

The case for capital account liberalisation was authoritatively put forward by Stanley Fischer, the former Deputy Managing Director of the International Monetary Fund, in the following terms:

- that the benefits of liberalising the capital account outweigh the potential costs;
- that countries need to prepare well for capital account liberalisation: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalised capital markets; and
- that an amendment of the IMF's Articles of Agreement is the best way of ensuring that capital account liberalisation is carried out in an orderly, non-disruptive way, that minimizes the risks that premature liberalisation could pose for an economy and its policymakers. (Fischer (1997))

The background to Fischer's statement was a proposal by the IMF Interim Committee at the 52nd Annual Meeting of the IMF and the World Bank in Hong Kong in April, 1997 at which the Committee proposed an amendment to the Fund's Articles of Agreement to extend the Fund's jurisdiction to capital movements. This amendment would make the liberalisation of international capital movements a central purpose of the Fund. As Fischer puts it: "In a nutshell, **the prime goal of the amendments would be to enable the Fund to promote the orderly liberalisation of capital movements.**" (Fischer (1997), p.12. Emphasis in the original).

It will be appreciated that under the original IMF Agreements the Fund was mandated to promote only current account liberalisation. It had no jurisdiction over a country's capital account except "the right to require countries to impose capital controls in certain contexts." However, as Fischer admits: "De facto, the Fund has become increasingly involved in helping member countries liberalise in a manner that does not undermine economic and financial stability."

Fischer suggests that, at a theoretical level, capital account liberalisation would lead to global economic efficiency, allocation of world savings to those who are able to use them most productively, and would thereby increase social welfare. Citizens of countries with free capital movements would be able to diversify their portfolios and thereby increase their risk-adjusted rates of return. It would enable corporations in these countries to raise capital in international markets at a lower cost. It is suggested, moreover, that such liberalisation leads to further development of a country's financial system which in turn is thought to enhance productivity in the real economy by facilitating transactions and by better allocation of resources. Some argue that free capital movements will help increase world welfare through another channel, namely transferring resources from ageing populations and lower rates of return in advanced countries to younger populations and higher rates of return in newly industrialising

economies. Such resource transfers will be Pareto optimal as both rich and poor countries would gain.

Summers (2000) succinctly sums up the core point of the orthodox perspective as follows: "... the abstract argument for a competitive financial system parallels the argument for competitive markets in general ... Just as trade in goods across jurisdictions has benefits, so too will intertemporal trade and trade that shares risks across jurisdictions have benefits."

Orthodox economists recognise that there are risks attached to capital account liberalisation. Markets sometimes overreact or react late or react too fast. However, as Fischer notes "While I believe we sometimes see examples of market overreactions and unjustified contagion effects, I also believe that capital movements are mostly appropriate: currency crises do not blow up out of a clear blue sky, but rather start as rational reactions to policy mistakes or external shocks. The problem is that once started, they may sometimes go too far." (Fischer (1997) pp 4-5) In general, Fisher believes that capital markets serve as an important discipline on government macro-economic and other policies "which improves overall economic performance by rewarding good policies and penalising bad." (Fischer (1997), p 4)

It will be useful to consider these arguments for capital account liberalisation initially at a relatively abstract level in the rest of this section and then in relation to empirical evidence in the following sections. The first important point to note is that, as in the case of the neo-classical argument for free trade, the maintenance of full employment and macro-economic stability constitute an important prerequisite for reaping the benefits of a globalised capital market. Specifically, as Rakshit (2001) suggests, the theoretical model of the beneficial effects of free capital movements makes the following assumptions:

- 1) resources are fully employed everywhere;
- 2) capital flows themselves do not stand in the way of attaining full employment or macroeconomic stability; and
- 3) the transfer of capital from one country to another is governed by long-term returns on investment in different countries.

The question whether these assumptions are likely to be valid under the current global economic regime is examined below.

II.3 The Case Against Free Capital Flows

The theoretical case against the view that unfettered capital movements are essential for maximising the gains from trade and world economic welfare has been made by a number of economists from different schools of thought. First within the neoclassical tradition itself, Stiglitz (2000) argues that the concept of free movements of capital is fundamentally different from that of free trade in goods. Capital flows are subject to asymmetric information, agency problems, adverse selection and moral hazard. Although such problems may occur also in trade in goods and services, they are intrinsic to financial flows and are far more important.

Importantly, there are also diverging views about the price formation process in asset markets such as the stock market and the currency markets. Orthodox economists subscribe to the theory of efficient markets. In this view, prices are a collective outcome of actions of a multitude of individual economic agents whose behaviour is assumed to be based on utility maximisation and rational expectations. This price formation process is thought to lead to efficient prices in these markets. A powerful counter-view is that put forward by John Maynard Keynes (1936) in chapter 12 of the *General Theory* and which is encapsulated in his well known "beauty contest" analogy which highlights the role of speculation in determining prices.

Thus, in Keynesian analysis, which has been formalised in recent theoretical contributions, price formation in asset markets may often be dominated by speculators or noise traders in modern parlance. Moreover, theoretical work on Darwinian selection mechanisms indicate that the Friedman (1953) assertion that rational investors will always wipe out speculators is far from being valid in all situations.⁴

Further the critical school emphasises that financial markets are particularly prone to co-ordination failures and often generate multiple equilibria, some good, some bad. In the absence of appropriate coordination by the government or international authorities, an economy may languish in a low level equilibrium, producing sub-optimal output and employment levels.

The post-Keynesian economists (see for example Davidson, 2001), take a more radical stance. They put forward analyses and evidence in favour of Keynes' thesis 'that flexible exchange rates and free international capital mobility are incompatible with global full employment and rapid economic growth in an era of multilateral free trade'. These economists also challenge the orthodox

presumption that transparency and availability of more information would make the financial markets less prone to crisis. They point out that the crises are fundamentally due to the fact that the future is uncertain and people have different perceptions about it.

Keynes was very sceptical about the ability of the world economy under free trade and free capital movements to maintain balance of payments equilibrium between countries at full employment levels of output. In a famous passage he observed, "... the problem of maintaining equilibrium in the balance of payments between countries has never been solved ... the failure to solve the problem has been a major cause of impoverishment and social discontent and even of wars and revolutions ... to suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium only if we trust to matters of laissez faire is a doctrinaire delusion which disregards the lessons of historical experience without having behind it the support of sound theory"(Moggridge, 1980:21-22). Consequently the Keynesian design for the post-war international financial system did not envisage free capital movements. As Felix (1998) notes, 'Reflecting views then dominant among Anglo-Saxon economists, the Bretton Woods Accords were devised around the basic thesis that free international capital mobility is incompatible with the preservation of reasonably free trade and full employment.'

Thus, the orthodox theory that financial liberalisation leads to global economic efficiency based on the analogy with free trade is flawed on several counts. Within the neoclassical tradition itself, it is the intrinsic nature of financial contracts which differentiates a market for the latter from that of ordinary goods in international trade: financial instruments are characterised by asymmetric information between borrowers and lenders and since such transactions take place over time they are also subject to time inconsistency problems. These in turn generate moral hazard, leading to contagion and multiple equilibria which can produce pathological outcomes. The Keynesian and the post-Keynesian emphasis is on inherent uncertainty about the future, on speculation and the macro-economic co-ordination failures at both the national and international levels to which financial markets are particularly prone.

3. Empirical Research on Financial Liberalisation and Economic Crisis

III.1 Banking and Currency Crises and the Real Economy

The theoretical expectation of free capital movements leading to smoother income and consumption trajectories for individuals and countries following economic shocks than would otherwise be the case, has been confounded by the experience of developing countries. There now exists substantial empirical evidence suggesting a close link between the liberalisation of the financial system and economic and financial crises particularly in developing countries. Developed countries, including the US, the UK and Scandinavian countries, have also been subject to such crises, but compared with developing countries, the incidence has been relatively low and the social costs correspondingly smaller. However, developing countries have suffered not only more but also deeper crises and virtual financial meltdowns.

To illustrate, Kaminsky and Reinhart's (1999) recent paper explored the links between banking crises, exchange rate crises and financial liberalisation. The sample consisted of twenty countries, of which fourteen were developing ones and it covered the period 1970-1995. The authors found that there was a sharp increase in both types of crises since 1980. The average number per year of banking crises in their sample rose from 0.3 during 1970-1979 to 1.4 in 1980-1995. The two authors found that the banking crises and the currency crises are closely related and that the banking crises are often preceded by financial liberalisation.

In their influential study Demirguc-Kunt and Detragiache (1998) examined banking crises during the period 1980-1984 for a sample of 53 developed and developing countries. They found that banking crisis is more likely to occur where the financial system has been liberalised. They also found a two-way interaction between banking and currency crisis. Where the banking systems are not sufficiently developed, with capital account liberalisation, banks become vulnerable to external economic shocks. The authors' findings suggest that vulnerability is reduced with institutional development and strengthening of the banking system through prudential regulation. They also found that financial liberalisation leads to an intensification of competition among banks and hence to greater moral hazard and risk-taking than before.

The recent Asian crisis provides almost a laboratory experiment for examining the role of capital account liberalisation in causing or exacerbating that region's severe economic downturn. Williamson (1998) provides evidence to suggest

that countries which did or did not have economic crisis were differentiated only by whether or not they had liberalised their capital accounts. Most economists would now agree that even if premature financial liberalisation without adequate prudential regulation was not the root cause of the crises in countries such as Thailand, Korea and Indonesia, it greatly contributed to the occurrence of the crisis and to its depth. Indeed, the economic fundamentals prior to the crisis of the affected countries were better than those of India, but the latter country was spared the crisis because of its control over the capital account. Similarly, China managed to avoid the crisis and continued to have fast economic growth. China also had not liberalised its capital account.⁵

It is argued by some that even with the acute economic crisis of 1998-1999, over the long run Korea with its economic openness was a much more successful economy than India. This argument has some plausibility but it overlooks the crucial fact that Korea's outstanding industrialisation record over the previous three decades was not accomplished by a liberalised financial system but rather by a highly controlled one. However, when the system was liberalised in the 1990s it was followed by an unprecedented crisis (see, also, Demetriades and Luintel, 2001).

III.2 Social and Economic Costs of the Crisis

The Asian crisis is extremely important in terms of its economic and social impact on the populations of the affected countries. The World Bank (2001) notes that 'In terms of lost output and the implications for poverty and unemployment, the Asian crisis represents one of the most acute periods of financial instability in this century' (page 73). The crisis greatly increased poverty, reduced employment and real wages and caused enormous social distress. Indeed the economic downturn was so enormous that in a country like Indonesia it led to a virtual disintegration of the social fabric of the country. This is why the Asian crisis is aptly termed, not just an ordinary slowing of GDP growth due to an economic shock, or a normal cyclical recession but an enormous meltdown. It is important to appreciate, however, that even if there is no meltdown, economic slowdowns or recessions have bigger social costs in developing than developed countries because of the lack of publicly provided social security in the former group. There is evidence that in both country groups the effects of a downturn fall disproportionately on the poor and on women (see further Singh and Zammit, 2000; Stiglitz, 1999 and World Bank, 1998/99).

Turning to an investigation of costs purely in economic terms, there are good analytical reasons to believe that economic crises would negatively affect both investment and long-term growth⁶. In addition, recessions and meltdowns also have fiscal and redistributive implications which may affect the economy for a long period of time. Caprio and Klingebiel (1996) estimates indicate that the costs of a banking crisis are typically quite large; their research indicated that these ranged from 3.2 per cent of GDP in the U.S. savings and loans crisis of 1984-1991 to 55.3 per cent for the banking crisis in Argentina from 1980-1982 (table 1).

Table 1. *Fiscal costs of banking crisis in selected countries (percentage of GDP)*

<i>Country</i>	<i>(Date)</i>	<i>Cost (percentage of GDP)</i>
Argentina	(1980-82)	55.3
Chile	(1981-3)	41.2
Uruguay	(1981-4)	31.2
Israel	(1977-83)	30.0
Cote d'Ivoire	(1988-91)	25.0
Senegal	(1988-91)	17.0
Spain	(1977-85)	16.8
Bulgaria	(1990s)	14.0
Mexico	(1995)	13.5
Hungary	(1991-5)	10.0
Finland	(1991-3)	8.0
Sweden	(1991)	6.4
Sri Lanka	(1989-93)	5.0
Malaysia	(1985-8)	4.7
Norway	(1987-9)	4.0
United States	(1984-91)	3.2

Source: Caprio and Klingebiel 1996. Quoted in Chang, (2001)

In a pioneering study Easterley et. al. (2000) have investigated economic instability for a large cross-section of developed and developing countries over the period 1960-1990. As table 2 indicates, developing countries typically suffer greater instability than developed countries with respect to output, employment, real wages, capital flows and terms of trade changes. In neo-classical analysis it is customary to attribute instability to the lack of flexibility in labour markets,

Table 2. Economic instability and related variables: differences between developing and high-income OECD Countries

<i>Variable value</i>	<i>Developing countries</i>		<i>High-income OECD countries</i>			
	<i>Mean</i>	<i>Number of observation</i>	<i>Mean</i>	<i>Number of observation</i>	<i>t-statistic for difference in means</i>	<i>P-</i>
Growth	0.007	163	0.027	23	-5.659	0.000
Standard deviation of growth	0.061	163	0.026	23	9.779	0.000
(Median standard deviation of growth)	0.052		0.022			
Standard deviation of employment	0.098	83	0.035	21	6.652	0.000
Standard deviation of real wage index	2.119	90	1.883	21	0.833	0.410
Standard deviation of real wage changes	1.197	85	0.321	21	8.116	0.000
Private capital flows / GDP	1.722	146	0.372	22	2.743	0.009
Standard deviation of private capital flows / GDP	2.662	138	2.311	22	0.808	0.420
Standard deviation of terms of trade changes	0.123	117	0.041	23	9.688	0.000
Standard deviation of money growth	0.219	148	0.077	20	6.757	0.000

particularly to wage rigidity. However, Easterley et al. find that despite greater labour market flexibility (measured by changes in real wages) in developing countries they exhibit greater volatility than developed countries (Table 2). The authors' results suggest that the characteristics of the financial system rather than the labour market are the more important causes of economic instability. Their econometric analysis shows that financial variables are statistically significant in explaining both volatility of GDP growth and the likelihood of a downturn. They find that openness and policy volatility also have a significant influence on growth volatility. In general, Easterly et al.'s findings suggest that countries with weak financial systems display greater instability in GDP growth in part because these institutional shortcomings amplify the effects of the volatility of capital flows.

III.3 Capital Account Liberalisation and Proximate Causes of Instability

The fundamental theoretical reasons why capital account liberalisation may lead to economic instability were analysed in Section II. In view of its huge economic and social costs, it would be useful to consider further empirical evidence on some of the proximate causes of the observed relationship between free capital movements and economic instability. The more important of these include:

- 1) Volatility in capital flows
- 2) Increased competition among banks following liberalisation as mentioned above;
- 3) The changes in the global financial system and the short-termism of the leading players.

The volatility and the pro-cyclicality of the private capital flows to developing countries is a well attested feature of international capital movements during the last two decades⁷. Such in-flows come in surges, often bearing no relationship to the economic fundamentals of the country and leave the country when they are most needed, i.e. in a downturn. As Williamson and Drabek (1998) note, even in a country such as Chile which was deeply integrated with the world financial markets, private foreign capital suddenly withdrew in the event of a fall in copper prices. There is however an important debate on the comparative volatility of the different components of capital flows, which will be reviewed in the following sections.

As to the effects of the volatility of capital flows. Ramey and Ramey (1995) found that it was positively related to volatility of GDP growth, a result confirmed by Easterly *et al.* (2000). The former two authors also reported a negative relationship between long-run economic growth and the volatility of GDP growth, a result again confirmed by Easterly *et al.* (2000), and also by World Bank 2001, among others. Table 3, from the latter publication, presents regression results of the effects of capital flows and their volatility on growth per capita, for a large sample of developing countries over successive decades, covering the period 1970-1998. The table also contains the normal control variables used in such cross-section analyses (e.g. initial GDP per capita, initial schooling, population growth rate, investment rates and a measure of policy). Volatility of capital flows is measured by the standard deviation of the flows. The dependant variable is the rate of growth of GDP per capita. The table suggests an economically important and statistically significant negative relationship between capital flow volatility and GDP growth per capita for the period as a whole 1970-1998. It is however interesting that the negative relationship becomes weaker over time, with the value of the relevant co-efficient rising from a statistically significant minus .322 during 1970-79 to minus .124 in 1990-98 when the co-efficient was also statistically insignificant. Other results from table 3 will be commented on in the following section.

Table 3. *Effects of capital flows and their volatility on growth per capita, by decade*

<i>Independent variable</i>	<i>Dependent variable: rate of GDP growth per capita</i>			
	<i>1970-98</i>	<i>1970-70</i>	<i>1980-89</i>	<i>1990-98</i>
Capital flows	0.287**	-0.149	0.133	0.275**
Capital flows volatility	-0.344**	-0.322**	-0.188	-0.124
Initial GDP per capital	-0.508**	-0.345	-0.940**	0.159
Initial schooling	1.429	-1.749	3.640*	-0.446
Population growth rate	-0.513**	-0.438	-0.573**	0.869**
Investment	0.182**	0.309**	0.164**	0.094**
Policy	0.008**	0.007**	0.011**	0.013**
Inflation rate	-0.002**	-0.008	-0.001**	-0.004**
Openness of the economy	0.001	0.006	0.001	-0.024**
Adjusted R ²	0.75	0.59	0.57	0.38
No. of Countries.	72	56	74	100

* denotes significance at the 10 per cent level, and ** at the 5 per cent level.

Source: World Bank (2001)

The next issue is why are the capital flows to developing countries so volatile? Analysis and evidence suggests that both internal (e.g. weak domestic financial systems; frequent economic shocks) and external factors, particularly the animal spirits of foreign investors, are involved in making these flows volatile.

Kindleberger (1984) has observed that financial markets are subject to frequent crises, which he ascribes to periodic and alternating bouts of irrational exuberance and pessimism of investors largely unrelated to fundamentals. Importantly, Kindleberger's historical analysis is implicitly endorsed by Alan Greenspan, the Chairman of the US Federal Reserve himself, who recently commented as follows on the 1987 US stock market crash and the Asian financial meltdown of the 1990s:

“At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point, and water (read, confidence) evacuates its reservoir. The United States experienced such a sudden change with the decline in stock prices of more than 20 per cent on October 19, 1987. There is no credible scenario that can readily explain so abrupt a change in the fundamentals of long-term valuation on that one day. ... But why do these events seem to erupt without some readily evident precursors? Certainly, the more extended the risk-taking, or more generally, the lower the discount factors applied to future outcomes, the more vulnerable are markets to a shock that abruptly triggers a revision in expectations and sets off a vicious cycle of contraction. ... Episodes of vicious cycles cannot easily be forecast, as our recent experience with Asia has demonstrated.” (Greenspan, 1998)

This mirrors the Keynesian view of investor behaviour and the significance of mass psychology in price formation in the financial markets, as discussed earlier. Keynes's insights on this subject have been formalised in current theoretical literature, which is able to provide a 'rational' explanation for the herd-like behaviour, contagion and other irrational manifestations of economic agents in financial markets.⁸

It is also important to emphasise another major factor in causing the volatility of external capital flows to developing countries. Kauffman (2000) and Williamson (2002) have stressed the significance of changes in the nature and character of the financial markets in enhancing capital flow volatility. The intense competition in the world fund management industry together with the nature of rewards offered to fund managers have helped to make the latter short-termist in their investment decisions⁹. As Kauffman (2000, p. 61) notes:

(In the new global financial system) most prominent banks, securities firms, and even a few insurance companies possess departments that emulate the trading and investment approach of the hedge funds. Even the corporate treasuries of a number of non-financial corporations are engaged in this activity. Once arcane and exotic, the hedge fund approach to investment has been mainstreamed

Finally, analysis and evidence for increased competition among banks following liberalisation is provided by Furman and Stiglitz (1999) and Stiglitz (2000) among others.

4. Evidence on Capital Account Liberalisation and Long Term Economic Growth

In principal it is possible for the instability caused by capital account liberalisation to be more than compensated for by faster long term economic growth arising from the greater availability of capital inflows. This is the promise held by the proponents of this policy regime (see for example Fisher (1997) and Summers (2000) referred to earlier). It will therefore be useful to review the available empirical evidence on this issue.

A good starting point is the broad brush approach adopted by Singh (1997a) in analysing this issue. He considers the case of advanced countries whose experience, he suggests, is relevant for developing economies. This is because the former have operated under a regime of relatively free trade and capital movements for nearly two decades - a period long enough to make at least a preliminary assessment of the effects of this economic regime on performance. Evidence suggests that the record has been less than impressive despite the fact that the world economy during this period has not been subject to any abnormal negative shocks like the oil price increases of 1973 and 1979. Indeed, the economic performance of industrial countries during this later period has been much worse than in the earlier period of the 1950s and 1960s when they functioned under a myriad of capital controls.

- GDP growth in the 1980s and 1990s under a liberal regime regarding private capital flows was much lower than that achieved in the “illiberal” and regulated “golden age” of the 1950s and 1960s;
- Productivity growth in the last fifteen years has been half of what it was in the “golden age”;

- The critical failure is, however, with respect to employment: 8 million people were unemployed in the OECD countries in 1970, but by the mid 1990s 35 million were unemployed, that is, 10 per cent of the labour force.

Singh's analysis also shows that the poor performance of industrial countries during the 1980s and 1990s cannot alternatively be ascribed to exogenous factors such as the exhaustion of technological opportunities, or to labour market imperfections. Industrial economies have more flexible markets today than they did in the golden age. In addition they have the benefit of a new technological paradigm of information and communication technology which many economic historians regard as on a par with the most important technological revolutions of the last two centuries. In view of all these factors - a new technological paradigm, more flexible markets, absence of economic shocks such as the oil shocks of 1973 and 1975 - orthodox analyses would suggest that OECD economies should be growing today at a much faster rate than in the golden age. But as we see the opposite has been true.

Eatwell's (1996) and Singh's (1997a) analysis indicates that the poor performance of industrial countries in the recent period is closely linked to intrinsic features of the liberal financial regime. Co-ordination failures have led to sub-optimal levels of the OECD and world aggregate demand, output and employment. When capital flows were regulated in the 1950s and 1960s, and there was successful co-ordination under the hegemony of the United States, payments balance between countries was achieved at much higher levels of output and employment than has subsequently been the case under financial liberalisation.

In contrast with the above broad brush approach, Rodrik (1998) has carried out an econometric analysis of the effects of capital account liberalisation on economic growth for developing countries. Controlling for the other relevant variables (such as those given in table 3) for a sample of 100 developing countries over the period 1975-89, he finds no relationship between the capital account regime in developing countries and the following three indicators of economic performance: (a) per capita GDP growth, (b) share of investment in GDP and (c) inflation.

On the face of it however the relevant regression results in Table 3 do not support the Rodrik conclusions. These results suggest that the volume of capital flows have on the whole a positive impact on GDP growth. This finding is nevertheless not necessarily in conflict with Rodrik's results because in Table 3 the effect of volatility of capital movements has been separately controlled for.

However, if both the volume and the volatility of capital flows were considered together, the results might be much the same as those of Rodrik.

Studies which disaggregate developing countries into different groups are able to find a more positive relationship between capital - flows and GDP growth. Thus Edwards (2000) suggests that there is no relationship between capital account liberalisation and economic growth in low income countries but the relationship becomes positive as the level of income rises. Similarly Eichengreen's (2000) review of a number of empirical studies suggests that the higher the level of income the greater the effect of capital inflows on GDP.

To summarise, the above review of empirical evidence on capital account liberalisation, capital inflows and the growth of GDP and its volatility indicates that there is a close relationship between liberalisation and economic and financial crises. This relationship is robust and in the circumstances of developing countries there are also strong analytical arguments for both its existence and robustness. On the other hand available evidence does not indicate that free capital flows necessarily lead to faster long-term economic growth for the typical developing country. In view of these facts, Stiglitz (2000) is fully justified in castigating the IMF for its promotion of capital account liberalisation. Not only is there no adequate theoretical or empirical case for such espousal but there is in fact a strong case against it. Indeed the economic crises and the instability which capital account liberalisation is seen to generate, may compromise a country's future economic development by inducing capital flight and lowering domestic investment and long-term economic growth.

5. Capital Account Liberalisation and FDI¹⁰

As explained in the Introduction that while finding a 'compelling' case against any general liberalisation of the capital account, Stiglitz (2000) also suggest that there is a 'compelling' case in favour of FDI. In view of the fickleness of the short term capital flows and the gyrations of the markets, he comprehensively rejects the argument that capital account liberalisation is desirable because it imposes discipline on countries forcing them to follow good economic policy. However, he states that " far more relevant for the long run success of the economy is the foreign direct investment and the desire to acquire and sustain FDI provide strong discipline on the economy and the political process " (p1080). Although, he does not specifically address this issue, Stiglitz comes close to accepting here the principles of a new proposal which is being put forward at the WTO by EU and Japan for a multilateral agreement on

investment (hereafter PMAI), covering only FDI. The background to this proposal is as follows. It will be recalled that three years ago the OECD countries failed to negotiate a Multilateral Agreement on Investment (MAI) amongst themselves, which was intended to be later acceded to by developing countries. PMAI is similar to MAI with a critical difference that unlike the latter the former will only be confined to FDI. This clearly represents a significant concession to developing countries. The advanced countries' preference would seem to be to establish a binding treaty at the WTO which would create for FDI a regime similar to that of (free) trade in goods.

In favouring FDI Stiglitz seems to be a part of a general consensus among economists which suggests that compared with debt and portfolio investment, FDI, apart from its other merits, is the safest source of funds for developing countries. It is thought to neither add to a country's debt, nor (being bricks and mortar) can it be quickly withdrawn from the country. Further, in view of the other virtues of FDI in bringing new technology, organisational methods etc, and importantly spill overs to domestic industry, the proponents claim that the case for PMAI becomes overwhelming.

Those propositions will be contested below and it will be argued that unfettered FDI is not in the best interests of developing countries. As in the case of short-term flows, FDI also requires appropriate regulation by these countries to enhance social welfare. As such measures would be denied to them by PMAI it is suggested here that poor countries should resist the proposed agreement.

It will be useful to begin this analysis by noting that there has also been a sea-change in developing countries' perspective on, and attitude towards, FDI. In the 1950s and 1960s, developing countries were often hostile towards multinational investment and sought to control multinational companies' activities through domestic and international regulations. However, during the last two decades emerging countries have been falling over themselves to attract as much multinational investment as they can.

This enormous shift in developing countries stance toward multinational investment is associated with the major changes which have occurred in the pattern of international capital flows to developing countries. The former may be regarded as both a cause and the consequence of the latter. The most important change in capital flows for the purpose of this paper is the emergence of FDI as a predominant source of external finance for developing countries during the 1990s. Between 1996 and 1998 FDI inflows to developing countries constituted about 10 per cent of their gross capital formation. (Singh, 2001;

UNCTAD, 2001). It is also important to note that alongside these changes in the pattern of external finance, analysis and evidence suggest that developing countries' need for external finance has greatly increased. This is in part due to the liberalisation of trade and capital flows in the international economy. UNCTAD (2000) suggests that because of these structural factors, developing countries have become more balance of payments constrained than before: the constraint begins to bite at a much slower growth rate than was the case previously in the 1970's and 1980's. In these circumstances it is not surprising that developing countries have radically changed their attitude towards FDI. There has also, therefore, been intense competition among these countries for attracting FDI.

This competition has resulted in a shift in the balance of power towards multinationals in their dealings with developing countries. An important objection to PMAI is that if it were approved it would, instead of redressing this imbalance, make it worse than before. This is because the Agreement would essentially give the multinationals a license to (or not to) invest wherever or whenever they like regardless of the circumstance and needs of developing countries.

It is important to observe that from the perspective of developing countries the present pattern of external resource flows including FDI flows is very unsatisfactory. A significant characteristic of FDI flows is that these are heavily concentrated in a few countries. These are normally countries, particularly those in East Asia, which already have very high savings and investment rates. On the other hand, low income and the Least Developed countries which have small saving rates because of their meagre levels of GDP per capita, do not get FDI or other external resources they need. Indeed, in broader terms, contrary to text book neo-classical economics, world resources do not go from the rich to the poor countries but instead are predominantly allocated to the rich countries including the richest among them, i.e., the US.¹¹ PMAI would do nothing to change this unsatisfactory pattern of resource flows; instead it is likely to accentuate these negative features.

6. FDI and Financial Fragility

Leaving aside other characteristics of FDI (to be discussed later), we will consider it first simply as a source of finance, and examine its implications for balance of payments and for macroeconomic management of the economy. In contrast to portfolio investments, FDI by definition is supposed to reflect a long term commitment as it involves normally a stake of 10% or more in a host

country enterprise together with managerial control.¹² In view of the latter element, the presumption is that the inflow of foreign capital in this form will be more stable than portfolio investments. The latter are easier to liquidate and following an internal or external shock, investors may quickly withdraw such funds from the host country.

There are, however, important arguments to suggest that the presumption of stability in net FDI inflows may not be correct. First, the distinction between FDI and portfolio investment has become very much weaker with the growth of derivatives and hedge funds. As Claessens *et al.*, (1995) observe, even at an elementary level it is easy to see how a long-term "bricks and mortar" investment can be converted into a readily liquid asset. They note that a direct investor can use his/her immovable assets to borrow in order to export capital and thereby generate rapid capital outflows.

Another reason why FDI may be volatile is because a large part of a country's measured FDI according to the IMF balance of payments conventions usually consists of retained profits. As profits are affected by the business cycle, they display considerable volatility. This also prevents FDI from being anti-cyclical and stabilising unless the host and home country economic cycles are out of phase with each other. That may or may not happen.

Further, there is evidence that like other sources of finance FDI flows can also at times come in surges. Apart from their contribution to volatility, these FDI surges, as those for example of portfolio investment can lead to equally undesirable consequences such as exchange rate appreciation and reduced competitiveness of a country's tradable sector.

Claessens *et al.* (1995) concluded that there were no statistically significant differences in the time series properties of the different forms of capital flows including FDI and that long-term flows were often as volatile as short-term flows. Williamson (2002) has suggested that this study may have failed to find differences between flows because it measured volatility in terms of the second moments of the time series instead of the ones of a higher order. The latter are relevant with respect to occasional 'meltdowns' which occurred for example in the Asian crisis. UNCTAD's 1998 study of the stability of capital flows between 1992 and 1997 found that FDI was relatively more stable than portfolio flows, but there were important exceptions. The latter included Brazil, South Korea and Taiwan. Lipsey (2001) also concluded that the FDI flows were relatively more stable overall.

It has been argued in favour of the FDI-stability thesis that during the Asian crisis and its aftermath, while bank lending and portfolio flows were sharply reversed, FDI continued much as before. However the motivation for this could have been what Krugman called the 'fire-sale' of devalued assets as a result of the crisis. Evidence, however, seems to suggest that it is more likely that the relative stability of FDI is due in part to the fact that the governments abolished regulations preventing or limiting FDI in domestic enterprises (albeit under IMF conditionality in the affected countries). Multinationals have used this opportunity to increase their holdings in local firms at cheap prices (World Bank (2001)).

Even if FDI is somewhat less volatile than other flows there are other important implications of FDI for a host country's balance of payments which need to be considered. These derive from the fact that an FDI investment creates foreign exchange liabilities not only now but also into the future. This characteristic leads to the danger that unfettered FDI may create a time profile of foreign exchange outflows (in the form of dividend payments or profits repatriation) and inflows (e.g., fresh FDI) which may be time inconsistent. Experience shows that such incompatibility, even in the short run may easily produce a liquidity crisis. The evidence from the Asian crisis countries with the latter suggests that it could in turn degenerate into a solvency crisis with serious adverse consequences for economic development. [See further Kregel (1996) and Singh (2001) on these points].

These considerations suggest that in order to avoid financial fragility the government would need to monitor and regulate the amount and timing of FDI. Since the nature of large FDI projects (whether or not for example these would produce exportable products or how large their imports would be) can also significantly affect the time profile of aggregate foreign exchange inflows and outflows, both in the short and long-term, the government may also need to regulate such investments. To the extent that the PMAI would not permit this kind of regulation of FDI, it would subject developing economies to much greater financial fragility than would otherwise be the case.

It could in principle, be argued that even if the financial fragility point is conceded, a PMAI may still benefit developing countries by generating greater overall FDI which could compensate for the increased financial fragility. However, this proposition is of doubtful validity. We saw earlier, that there has been a huge increase in FDI in the 1990s. This occurred without any MAI and was clearly a product of a number of other factors.¹³ Similarly, there does not seem to be any connection between regulatory constraints on FDI and the total

amount of FDI which a country may be able to attract. Malaysia (see further US, 1996) and China, (see Braunstein and Epstein, 1999), to illustrate, are large recipients of FDI despite having significant control and regulation over FDI projects.

7. FDI and Real Economy, Technology Transfer, Spill-overs, Investment and Savings

Apart from FDI as a source of finance two of the most important ways in which a developing country may benefit from such investments is through (a) transfer of technology and (b) from spill-overs. The latter refer to the effects of FDI on raising productivity in local firms. These firms may be helped by foreign investment in a variety of ways, including the demonstration effect of the new technology and the enhancement of the quality of inputs which such investment may promote. On the other hand there may be few positive or even negative spill-overs, if FDI leads to local firms being forced out of the market because of greater competition.

Both issues of technology transfer and spill-overs have been widely studied and there exists on these subjects a large and controversial literature. The main lesson which however comes from these writings in relation to the question of technology transfer is that a country is more likely to benefit from multinational investment if the latter is integrated into its national development and technological plans (see further Dunning (1994), Freeman (1989), Milberg (1999), South Centre (2000)). This is the reason why, other than Hong Kong, most successful Asian countries (including China and Malaysia as seen above) have not allowed unfettered FDI but have extensively regulated it. On the issue of spill-overs, early studies were quite optimistic about the positive externalities from FDI on domestic industries. However, these studies suffered from severe methodological difficulties particularly in relation to the question of causation. More recent research which uses more up-to-date methodology as well as large micro-economic data sets arrives at much more pessimistic conclusions. Thus, in an influential study, Aitken and Harrison (1999) found that in Venezuela multi-national investment had a negative effect on productivity of domestic plants in the industry. Such results are quite common from micro-level data (Hanson (2001)). In policy terms they reinforce the caution against unfettered FDI flows.

A critical issue in evaluating the effects of FDI on the real economy is its impact on domestic savings and investments. Economic theory does not yield any unambiguous predictions about how domestic investment may be affected

by foreign capital inflows. In general, this would depend upon the level of development of the economy, its degree of integration with international economy and its absorptive capacity. Table 4 shows the results of World Bank's analysis of the impact of various types of capital flows on investments and savings for a large cross-section of developing countries for the period 1972-1998. The results show that although FDI is positively associated with the investment, there is little relationship with savings. The long term bank lending has a more important influence on investment than does FDI. Portfolio investment is, on the other hand, associated more with savings than with investments.

A more interesting analysis of this issue is reported in the recent study by Agosin and Meyer (2000). This study is able to examine the regional variations in the effects of FDI on the 'crowding' in and out of domestic investment. The two authors' research covered the period 1970-1996 and included host countries from all three developing regions, Africa, Asia and Latin America. The results of the econometric exercise suggest that over this long period there was a strong "crowding in" in Asia, "crowding out" in Latin America and more or less neutral effects in Africa. Agosin and Mayer conclude:

"The main conclusion that emerges from this analysis is that the positive impacts of FDI on domestic investment are not assured. In some cases, total investment may increase much less than FDI, or may even fail to rise when a country experiences an increase in FDI. Therefore, the assumption that underpins policy toward FDI in most developing countries - that FDI is always good for a country's development and that a liberal policy toward MNEs is sufficient to ensure positive effects - fails to be upheld by the data." (p.14)

They go on to note:

"...the most far-reaching liberalisations of FDI regimes in the 1990s took place in Latin America, and that FDI regimes in Asia have remained the least liberal in the developing world... Nonetheless, it is in these countries that there is strongest evidence of CI (crowding in). In Latin America, on the other hand,...liberalisation does not appear to have led to CI." (p.14)

The policy implications of this analysis of FDI in relation to technology and spill-overs reinforce the message of the last section: developing countries need to regulate FDI closely in order for it to promote economic development and not to hinder it.

<i>Independent Variables</i>	<i>Dependent Variables</i>											
	Investment (1A)	Saving (1B)	Investment (2A)	Saving (2B)	Investment (3A)	Saving (3B)	Investment (4A)	Saving (4B)	Investment (5A)	Saving (5B)	Investment (6A)	Saving (6B)
Aggregate capital flows		0.72**	0.03									
Long-term capital			0.88**	0.10								
Bank lending					1.45**	-0.17						
FDI								0.84**	-0.03			
Portfolio investment										0.50	0.84*	
Short-term debt											0.23**	0.05
All other flows			0.22	-0.16	0.53**	-0.03	0.58**	-0.23	0.52**	-0.27	0.62	0.06
Growth rate, lagged	0.33**	0.33**	0.31**	0.36**	0.33**	0.46**	0.36**	0.45**	0.49**	0.48**	0.32**	0.39**
Change in terms of trade	0.01	0.04**	0.01	0.04**	0.01	0.05**	0.02**	0.05**	-0.00	0.04**	0.01**	0.05**
Inflation, lagged	-0.00	-0.00**	-0.00	-0.00**	0.00	-	-0.00	-0.00**	-0.00	-0.00*	-0.00	-0.00
Adjusted R ²	0.70	0.70	0.70	0.70	0.71	0.72	0.72	0.71	0.72	0.73	0.73	0.73

*denotes significance at the 10 percent level, ** at the 5 percent level.

Table 4. Marginal impact of various types of capital flows on investment and saving

Note. Fixed-effects regressions of investment (or saving) ratios against capital flows based on an unbalanced sample, consisting of a maximum of 118 countries, spanning the period 1972-98. The method of estimation was two-stage least squares, when a good instrument could be found; otherwise simple ordinary least squares results are reported.

Source: World Bank, (2001).

In broad analytical terms, the case for such government interventions in the FDI process lies essentially in various kinds of market failures. Co-ordination problems abound in relation to investment, including foreign investment, and in the presence of non-existent or incomplete markets typical in a developing economy, governments need to intervene to address co-ordination failures. It may be argued that these markets failures may turn out to be less important than government failures. That is certainly true in some cases, but it must be remembered that the developing world also contains a large number of highly successful governments, the so-called 'developmental states' in the newly industrialising countries (NICs). If developing countries are to attract the right kind of FDI in the right amounts, and to be able to obtain the maximum benefit from these, they need to guide the process and therefore must have effective states and appropriate institutional mechanisms. On the basis of case studies of several late industrialising economies, Amsden (2001) suggests that only those countries have been successful in the industrialisation process which were able to develop institutional mechanisms for ensuring autonomous state action in the economy.

8. Conclusion

The first part of the paper examined the theoretical and empirical case for full capital account liberalisation in developing countries and found it wanting. Indeed, as Stiglitz suggests, there is a compelling case against it. The second part considered the question of long-term capital account liberalisation only, that of FDI. Most economists, including Stiglitz, favour such capital flows into developing countries. On closer analysis, however, it is shown here that even FDI, if unregulated, may do more harm than good to these countries. It is therefore suggested that developing countries should resist the new multilateral agreement on investment which Japan and the EU are proposing, even though it will cover only FDI.

Notes

- ¹ For a comprehensive and recent contribution see for example Feldstein (2002)
- ² This section of the paper draws on Chakravarty and Singh (1988)
- ³ See further Freeman (1989); Chang (1995); Singh (1995).
- ⁴ On this set of issues, see for example, Stiglitz (1994); Allen and Gale (2000); Glen, Lee and Singh (2000)
- ⁵ For fuller discussion of these issues see Singh (2002a); Jomo (2001); Singh and Weisse (1999) and Rodrik (2000).
- ⁶ See further Pindyck (1991); World Bank (2001); Easterly et al (2000)
- ⁷ See further Williamson (2002); Occampo (2001); Singh and Zammit (2000); Stiglitz (2000)
- ⁸ See further, Shiller (2000); Singh and Weisse (1999); Singh (1999).
- ⁹ For a fuller discussion of the issues involved in this argument see Cosh, Hughes and Singh (1990) and Singh (2000).
- ¹⁰ This and the following sections are based on Singh (2001).
- ¹¹ See further Lucas (1990) and Sakakibara (2000).
- ¹² This is the empirical definition of FDI adopted by many countries to distinguish it from portfolio flows.
- ¹³ See further Singh (1997a, 1997b); Singh and Weisse (1998).

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