BRAZIL CAPITAL FLOWS CONFERENCE: *CAPITAL FLOWS: BLESSING OR CURSE?*
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I. Theory and Evidence

- **Standard economic and portfolio theory suggests that capital account liberalization is generally welfare improving**. By opening its capital account, a country could reduce the cost of raising capital (in both equity and debt markets), encourage investment, and increase economic growth over the medium term. Moreover, the country's income volatility would decline, as the stock of financial savings becomes more diversified and less correlated with fluctuations in domestic output. Access to international financial markets also allows for smoother consumption.

- **However, influential empirical studies seem to contradict the theory that opening fosters growth and stability**. For example, research by some former Fund colleagues (Prasad, Rajan and Subramanian (2007)), as well as others, suggests that capital account openness is often associated with lower economic growth. In recent years, economists have tried to shed some light on this inherent contradiction. Mody and Murshid (2005) find that there is a close link between inflows and investment in countries with stronger policy environments—countries with good institutions stand to benefit from capital account liberalization, while those with weak policy frameworks could become worse off.[1]

II. The True Dilemma: Need to Be Ready to Ride

- **The question is then not whether countries should open their capital account, but rather when and how they should sequence that process.** This is very difficult task, and history is plagued with examples of countries that liberalized their capital account too early and too quickly (Korea and Thailand 1997-98, Chile 1980s). Opening the capital account brings new challenges in terms of institution building, and this was very much an issue I struggled with in Chile, both at the Central Bank during the 1990s and as Finance Minister during the 2000s. I cannot emphasize enough the daunting nature of these institution-building challenges, and the need for countries to move slowly and with extreme caution.

- It would be relatively straightforward for an emerging economy to open its capital account if it could rely on a *steady* inflow of capital to finance a moderate and desirable current account deficit, say, for example of 2-3 percent of GDP. **The problem is that in**

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[1] Kose, Prasad, Rogoff and Wei (2006) find that benefits to capital account openness are indirect (they catalyze a strengthening in governance and institutions) and increase with the level of development.

reality inflows are much more fickle and volatile; sometimes they are too large, in other moments too small, and can even become outflows.

- **So, what is needed to manage the transition towards a more open capital account to contain the risks? To start, one needs a "consistent and credible" macro framework**. This would imply that countries with fixed exchange rates can open their capital accounts provided their fiscal frameworks are sufficiently flexible to deal highly volatile inflows. On the other hand, countries with independent monetary policy need to learn to live with greater exchange rate volatility, though this has proven difficult to implement.
    - Countries are often reluctant to allow much exchange rate flexibility, **fearing a large depreciation of their currency** in the event of an external financing shock. Having weak nominal anchors has been one critical problem – depreciation cannot be tolerated because of its inflation effects. The solution is to invest in a solid monetary framework.
    - There is also the problem of **vulnerable balance sheets**. In many dollarized economies, with a past history of hyperinflation, household and corporate liabilities are denominated in foreign currency, and a large depreciation could compromise financial stability.
    - *How to get out of the trap?* **Derivatives markets** allow firms to protect themselves against larger exchange rate fluctuations, and this market would develop only if there is exchange rate flexibility. Perhaps more importantly, increased exchange rate flexibility is necessary to ensure that **private agents internalize the risk** of increasing their foreign exchange exposure.
    - In addition, **a deep capital market** is always helpful to absorb changes in the supply of reserve currency without too much disruption in asset prices, including the exchange rate. In that regard, countries should avoid fully liberalizing their capital accounts until the process of financial deepening has advanced to a considerable extent. Chile, East Asia, Eastern and peripheral Europe (and even Spain) are dramatic examples of the inability of economies with underdeveloped local markets to absorb enlarged access to external financing without a major derailing of their trajectories.

- **Apart from strengthening macro frameworks, a well regulated financial system is critical to limit private sector excesses and boom-bust credit cycles.** This must be complemented by increased oversight of corporates, which usually operate outside the purview of regulators. External indebtedness by corporates, on top of potentially affecting the domestic financial sector, could impact the country's creditworthiness, particularly if bailouts are required to avoid large scale bankruptcies and unemployment.

- **The current juncture of unprecedented favorable external conditions is a good example of these challenges, as well as the importance of *adapting the policy toolkit* when traditional macroeconomic policies alone are not enough.**
    - For example, some **foreign exchange intervention** may be needed, particularly once exchange rates are overvalued or reserves are not overly high. In fact, our own research shows that while f/x intervention cannot alter the level of the real exchange rate persistently, it can be an effective instrument in slowing the "speed of appreciation," particularly if not done too early.
    - Similarly, **"temporary" capital account restrictions** could be considered, particularly when financial deepening has not taken place and gaps exist in the regulatory and supervisory infrastructure. In certain situations, capital controls could even help to buy time, even though they can't substitute for fundamental adjustment in macro policies.

III. What About Dutch Disease?

- **While the benefits of capital account liberalization are dependent on a well-synchronized institution building process, arguments against liberalization are also made on "Dutch Disease" concerns.** The opening of a country's capital account results in an appreciation of the exchange rate and a loss in competitiveness. In fact, the more you open up, the more you appreciate [particularly if your current account norm is a large deficit].[2] This potential cost is a source of concern for many policy makers, particularly in the region, that look to Asia as an example of successful export-led growth:
    - First, the empirical evidence of *Dutch Disease* is far from conclusive, and it's **still unclear if the *tradable sector* has a large positive externality** or spillover to the rest of the economy that warrants its protection. Empirical studies have shown that while currency appreciation leads to some reallocation of resources from tradables to non-tradables, this reallocation has not been shown to have a negative impact on long-term growth.
    - Second, assuming there is some type of "externality," **it is unclear whether one would want to restrict the capital account to promote the development of the tradable sector**. Instead, it seems like it would make much more sense to boost investment in infrastructure and human capital (specific to tradable sector needs).
    - Third, **Latin America is very different than Asia,** and as a result it's unclear whether the best strategy is to emulate Asia's growth model.

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[2] Rodrik and Subramanian (2008) argue that in countries with weak institutions, capital inflows may be disproportionately used to finance consumption, leading to an overvalued exchange rate and greater reduction in the profitability of investment.

- For one, Asia has much **higher savings rates** than Latin America, which helps to explain its much stronger current account position.
- The regions have very **different comparative advantages**. Latin America likely has a comparative advantage in products with "backward linkages" with raw materials---that is machinery and technology for the production/extraction of natural resources. Asia, on the other hand, specializes in goods with forward linkages—those based on the processing of raw materials.
- Finally, the **elasticity of exports** to exchange rate fluctuations is likely higher in Asia than in Latin America, given that exports in Asia are somewhat more labor intensive. On these issues, more research is needed.

IV. Final Remarks

- **To summarize, open capital accounts can potentially improve a country's welfare only if properly timed and synchronized with the strengthening of policy frameworks**. While this process is daunting and countries should proceed with caution, the volatility of capital flows should not be seen as an argument for countries to shut their capital accounts. Instead, emphasis should be placed on improving policy frameworks to better manage often large swings in inflows.
- Recognizing the challenges of financial integration and openness, **the international community** (through the IMF) has been active in recent years in helping countries cope with the volatility of capital inflows by making available more flexible lending and global insurance instruments. In addition, the Fund has been advising major countries like the United States on ways to improve their own policies—both macroeconomic and financial sector policies—so as to promote stability in global capital markets, to increase the benefits of financial integration markets for all countries.

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