Capital Inflows: Blessing or Curse?

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Theory and Evidence

- Capital account liberalization is generally welfare improving according to standard theory
- Empirical studies seem to contradict the theory that opening fosters growth and stability
- Policy framework/institutions matter in determining success

The True Dilemma: *Need to Be Ready to Ride*

- Question is then not whether to open, but rather when and how it should sequenced
- Institution-building challenges are daunting: need to move slowly and with extreme caution

How best to sequence liberalization?

- Building consistent and credible macro framework (takes time)
  - ✓ Fear of floating (hyperinflation/dollarization)
  - ✓ Original sin (balance sheet vulnerabilities)
  - ✓ XR flexibility to reduce risk-taking and develop derivates mkts
- Strengthen financial sector supervision / Watch out for corporates
- Financial Deepening

How to manage today's unprecedented abundance?

- Broaden policy toolkit if macro policies are not enough
- F/X intervention, but not too early (modality matters)
- Temporary capital account restrictions could be considered

How about Dutch Disease?

- Capital account openness brings about exchange rate appreciation. Loss of competitiveness is potentially larger for countries with current account "deficit" norms (like Latin America)
- Vast literature suggests no clear negative impact on growth
- Should Latin America follow Asia's model?
  - ✓ Asia has higher savings, different comparative advantage, and likely higher export elasticity.

Key takeaways

- Timing and sequence of openness matters
- Move cautiously: institution-building challenges are daunting
- International community is doing its part (flexible credit line)