

The political economy of capital flow cycles

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Focus on two dimensions

- Domestic aspects
- Political economy factors
- *Not* to exclude other considerations – global, economic




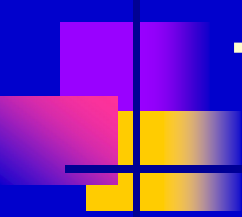
The national cycle, stylized

- Capital inflow 
- Domestic economic expansion 
- Real appreciation 
 - Consumption boom
 - Investment boom: finance, real estate, other nontradables
 - Quickening of capital inflow



The cycle continues

- Problems surface 
 - Competitive pressures on tradables producers
 - Debt overhang/currency mismatch
 - Concern about sustainability of exchange rate



The cycle ends – with a crash?

- Complaints of “overvaluation”
- Expectations of depreciation
- Capital inflows slow, perhaps reverse
- Reserves drawn down
- Currency crisis, banking crisis, mutual recriminations



Policy alternatives

- With respect to currency:
 - Sterilization and concerted effort to avoid real/nominal appreciation
 - Exchange rate flexibility, sooner or later
 - But alternative roads rarely taken; delay is common



The pattern is familiar

- Argentina 2001
- Russia 1998
- East Asia 1997-1998
- Mexico 1994, 1982, 1976
- Brazil 1889, Argentina 1890, United States 1893, Germany 1931...



But not universal

- Brazil 1999
- East Asia 1978-1985 (cf. Latin America)
- Other cases in which currency and/or banking crisis is avoided



Why is delay so common?

- Underlying political tension
- Resistance to depreciation from:
 - Consumers, especially middle classes
 - Those with foreign currency liabilities
- Resistance to real appreciation from:
 - Tradables producers: import-competers, exporters



Conflicting political pressures

- Consumers vote: impending elections cause delay in exchange rate adjustment
- Concern for private debtors (and public ones) causes further delay
- But drumbeat of protest from manufacturers, farmers calls for action



Political variables to consider

- Sensitivity to consumer interests
- Elections – timing and pivotal groups
- Influence of special interests – foreign currency debtors, import competitors, exporters
- Democracy, consumers, debtors vs. tradables producers (Latin America vs. East Asia?)



National responses to global cycles: Political economy rules

- Little national impact on global cycle
- But national responses vary widely; policy can exacerbate or mitigate cycle
- Policy response confronts political tensions
- Political pressures pull policymakers in different directions
- Character and impact of pressures vary
- Political economy of capital flows, and their cycles, worthy of further research