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Capital bonanzas

Sep 25th 2008
From The Economist print edition

Does Wall Street's meltdown show financial globalisation itself is part of the problem?

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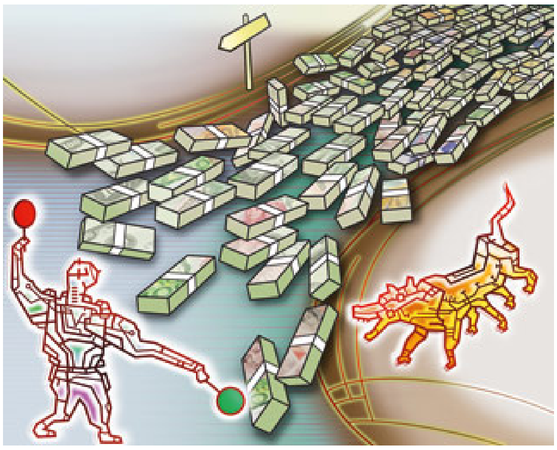

"THANK God," said one Latin American finance minister earlier this year. "At least this time it isn't our fault."

The meltdown of America's financial system may look very different from the emerging-market crises that overwhelmed Thailand in 1997 or Russia in 1998. This time there has been no currency collapse, no government default. Then, there were no collateralised-debt obligations or credit-default swaps.

Yet the minister was justified in seeing parallels between America's crisis and the emerging-market episodes. In all of them vast current-account deficits were financed by huge capital inflows. The afflicted countries saw housing speculation, asset bubbles and cheap loans followed by a credit crunch and the seizing up of the financial system. And Wall Street's meltdown raises the same questions as the crises of a decade ago: what will the direct effects on emerging markets be? If the world's richest economies are vulnerable to global financial turmoil, should developing countries not seek to insulate themselves from it?

Two recent papers* cast light on these questions. They conclude that, although financial globalisation has big costs, these can be minimised and potential gains increased by better policy. Financial globalisation itself, they imply, ought to be seen not so much as a bad thing, but as too much of a good one.

Beware markets bearing gifts

Most emerging markets see their ability to attract foreign money as proof of good management. From this point of view, it should be a blessing that private capital flows to developing countries rose, according to the World Bank, to $1 trillion in 2007, the highest ever. Yet if the study by Carmen and Vincent Reinhart is anything to go by, this should be little cause for celebration.

Taking the experience of 181 countries since 1980, the authors reckon that middle- and low-income countries had a roughly 20% chance of suffering a banking crisis and a 30% chance of a currency crisis, external-debt default or inflation spike (to more than 20% a year) if they experienced what the authors call a "capital-flow bonanza" in the three years beforehand. (They define such a bonanza as an unusual shift of the current account into the red, using that as a proxy for capital inflows since the capital and current accounts mirror each other.) These seem unenviable odds.

The authors point out that countries might have suffered disasters anyway, without being showered with money. That turns out to be true—but their chances were quite a bit lower: between 14% and 24% for countries that did not attract so many dollars. In other words, a foreign inflow, as well as financing good things such as public infrastructure and corporate investment, is also associated with debt defaults, inflation and currency crises.

The authors focus on the level of capital flows, rather than their composition. Presumably, countries that attract more foreign direct investment suffer less than those that have a greater amount of footloose portfolio investment or short-term bank lending. But overall, most countries that suck in foreign money show the classic signs of an economic bubble. Using a subset of 66 countries for which there are more detailed figures, the authors show that share prices rose by more than 10% in real terms in the two years before what they call a bonanza, then fell relentlessly for four years, ending below where they started. House prices went up by more than that—15% in real terms over four years during a bonanza—before falling back.

So why would countries seek out foreign money at all, if its impact is so malign? The answer is that it is not so much the amount of investment that is the trouble; it is its volatility, and especially its tendency to dry up. That makes today's climate worrying. Mansoor Dailami, the World Bank's manager of international finance, says private inflows to emerging markets may fall from $1 trillion to only $800 billion-850 billion this year. That may be particularly troublesome because of another difference between this crisis and the Asian one: in 1997-98, more debt was sovereign. Now, much of it is corporate, taken out by Indian, Chinese and other emerging-market companies. That implies a global credit tightening could have as big an impact on emerging markets as slowing import demand in the rich world.

Critics of financial globalisation argue that these problems are so great that emerging markets ought to be insulating themselves through capital controls. Many have been doing so. Yet even setting aside doubts about how far this is desirable (it is hard to believe growth in India or Brazil would have reached today's levels without foreign capital), the studies raise questions about whether capital controls are really the right response.

The second study points out that "sudden stops" of capital inflows tend to be an inverted U-shape: the poorest countries are the least vulnerable to global financial shocks; middle-income countries are the most; but, as you get richer and more integrated into global finance, your vulnerability tends to fall again—and that remains true despite the crisis in America. So it might still make sense for countries like India and Brazil to carry on liberalising. Moreover, as the Reinharts show, a big part of the problem is that capital flows are endemically boom-bust: money floods in and out. They argue that fiscal policy should be used to smooth out such cycles: governments should reduce deficits or run surpluses during bonanzas—the opposite of what they usually do. This implies something of a paradox. Capital flows are supposed to be a reward for good economic behaviour. But as Dani Rodrik, a Harvard professor, says, "these policy conclusions turn capital inflows into an imperative for even deeper reform."

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* "Capital Flow Bonanzas" by Carmen Reinhart and Vincent Reinhart. National Bureau of Economic Research (NBER) Working Paper No. 14321.
"Systemic Sudden Stops" by Guillermo Calvo, Alejandro Izquierdo and Luis-Fernando Mejía. NBER Working Paper No. 14026.