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Must large capital inflows always end in crisis?

May 4, 2010 10:30am |

The question I wish to pose for the next two weeks is whether it is possible for countries to accept large net inflows of capital from abroad, without ending up in crisis. If not, how do we manage a world of capital mobility?

This may seem a rather abstract problem. But I find it among the most important of all challenges confronting the world economy. It is the principal topic of my recent book, Fixing Global Finance (of which an updated edition has recently appeared). The view I have derived from the last three decades of experience is that it is almost an iron rule that, whenever countries run really large and sustained current account deficits (more than 5 per cent of GDP, or so), they end up in financial crisis. Carmen Reinhart and Kenneth Rogoff provide strong support for this view in their recent masterpiece, This Time is Different (Princeton University Press).

That is what happened to the Latin American countries in the debt crisis that erupted in 1982 and to the Asian countries in the crisis that erupted in 1997. It is also what happened in the current financial crisis, whose epicentre has been in countries that ran large current account deficits, notably, the US, Spain, UK and a number of countries in central and eastern Europe. Meanwhile surplus countries were affected indirectly, via losses of export markets and of the value of their assets held abroad.

Why is running current account deficits so dangerous? There are four reasons: first, it often means unsustainable asset price bubbles in the capital-importing country; second, it means unsustainable build-ups of debt in the private and public sectors of the capital-importing economy; third, it often means an unsustainable expansion of the financial system, characterized by excessive leverage and excessive build-ups of risky assets financed by supposedly risk-free liabilities; finally, it also often means a build-up of currency mismatches within the economy, particularly in the financial system, which makes the economy extremely vulnerable to currency collapses.

Mindful of these risks many emerging market economies have tried to insulate themselves, by keeping exchange rates down and recycling current account surpluses. This is one of the reasons that the crisis erupted this time in developed countries. Even the US was not immune. Though it has no problem of currency mismatches and little difficulty in financing external deficits, the financial system was damaged by the implosion of the bubble economy. Of course, as I have argued in previous columns, a similar problem exists within the eurozone, between the surplus and deficit countries. The absence of currency risk merely means that the stresses have emerged as credit risk.

So where do we go from here? The markets, partly driven by cheap money in the developed countries, are now trying to push emerging economies into current account deficit. The latter, in turn, are resisting. Should they continue to do so? After all, this is not costless. By resisting currency appreciation, emerging economies risk higher inflation, instead. On the other hand, emerging countries are right to be concerned about the longer-run consequences of large current account deficits. At the same time, it might ultimately be very disruptive to see huge current account deficits and financial excesses re-emerge in the US.

What, then, are the policy options for taming these extremes? A new global monetary regime? Capital controls? What other ideas do people have?

May 4, 2010 10:30am in Capital inflows, Economics, Financial crisis | 29 comments

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Bryan Lewis | May 4 12:06pm | Permalink Report

Would you include the reparations that the allies obtained and attempted to obtain from Germany after WWI as net capital inflows and if so do you believe these affected events in the late 1920's?

Jean-Pierre Kellens | May 4 12:35pm | Permalink Report

A current account deficit reveals a country's imbalance between ability to produce goods and services, and level of private and public consumption.
In a world of free trade and capital mobility, nobody cares about this imbalance and any idea of supporting local production is frowned upon as protectionist.
Not so long ago, the US, UK, Ireland, Spain and others were regularly praised for their high growth, while their external accounts received little attention.
But with growing imbalances at every level, it is only a matter of time before highly leveraged households, companies or governments default. US sub primes were the first default story; sovereign debt is the next one. The less self sufficient the various countries and regions of the world, the more debt and fragility in the global system, the more unemployment and the more environmental impacts. We may hate this idea, but we may have to draw its consequences.

Anthony J Peter | May 4 12:43pm | Permalink Report

Indeed a vital and valid topic Martin, thank you.

The imbalance issues we have encountered and will continue to experience can at least to a large part be traced back to disruptions to free market pricing. One set of disruptive forces I could term "policy active" include; holding the risk cost of capital (interest rates) artificially low, interferences in currency pricing (,e.g. via pegging or clustering incompatible economies under one currency), direct policy intervention (taxes / subsidies), etc. Another set of disruptive forces of recent history I could term "financial blinding" relate to distortions to the markets ability to view and assess true risk, e.g. the development of complex derivates (CDOs & co.). These are surely not the only disruptive groups at play but they seem to be able to unleash an incredible force.
The cause for such disruptive forces is of course government and national interest motivated by short to mid-term gains on the one hand, and the financial industry's appetite for growth well beyond fundamentals. The "financial blinding" causes may be marginally tamed for now by some form of financial market regulation, albeit I won't hold my breath. The "policy active" causes will surely not recede or disappear.
I particularly fear excessive use of disruptive active policy well beyond the current crisis repair mandate in the largest economies. This will, and already has, sown the seeds for the next crisis!

Realist, not a cynic | May 4 12:47pm | Permalink Report

slightly surprised that you regard it as an 'abstract problem' as I agree that these is the central issue and key to the current 'crisis'; without addressing it head-on the problems will simply be deferred to another day, and quite probably made worse. One might have expected economists world-wide and our European architects to be completely aware of the history of these crises. I read Rogoff and Reinhardt's book back in 2008 when it was originally doing the rounds in the city and agree it is an excellent piece of work, but if this isn't precisely the sort of analysis that economists *do* as a matter of course then I wouldn't mind knowing what exactly they do do! If one really wishes to address financial crises then it seems to me a discussion of fractional reserve banking, money-printing in general, and international currency speculation must be in order too (how many businesses have effectively been based on simple currency speculation a la primark? such a business increases risk in the financial system).

In terms of 'fixing' the crisis, historically what happened is that capital returned to the source of global capital (i.e. the US) which tended also to experience a recession albeit milder than the periphery countries (Asia, Eastern Europe etc.) who experienced harsh deflationary depressions. However, government intervention has stalled this for now. Is it really different this time? Reinhardt and Rogoff's book is cleverly named: like all economists they would rather sit on the fence until after the event, but the title could also be interpreted as suggesting that we would be arrogant to believe that it won't which then implies that the stimulus packages today have only delayed the inevitable and in may in fact have made things worse.

The evidence suggests that on the balance of probabilities (the clear pattern with previous crises), governments should try to manage deflation and default in the most orderly fashion possible and be open and transparent about the true state of affairs, rather than trying to defy the laws of nature/gamble with bailout after bailout of taxpayer's money. Unfortunately this does not appear to be happening!

Apologies for the crudeness of my response, I am not an economist but to a former scientist (and subsequent practitioner), my arguments seem obvious (particularly the last paragraph) but I hear them rather infrequently. Yes, it may be politically impractical but for a debate one might think it should be a good starting point?

Luis H Arroyo | May 4 1:41pm | Permalink Report

Interesting question, Mr. Wolf
I don´t see the capital flows as one of the main causes of the crisis. I suppose it is a sign of other disturbances; for instance, the cumulative maladjustment of exchange rate -especially in the euro zone, but also the Yuan-$ exchange rate.
In general, I tend to believe that the old Hume´s specie flow mechanism is a correct, quite simple, description of flow direction. If there is no compensation mechanism (flows of gold, exchange rate, interest rate and or prices), the direction of flows continues without end.
That has contributed to the transmission and magnificence of the crisis, but not to the origin of it. I think the general mistaken in risk evaluation is in the roots of the crisis.

Greg J Fisher | May 4 1:43pm | Permalink Report

Martin,

I don't think we will understand these issues rigorously enough until we start to seriously think about the economic and financial systems as a whole, complex system.

The financial crisis has demonstrated (yet again) that the financial system does not necessarily allocate investment resources optimally. This can be true both intra- and inter-regionally. It is not particularly difficult to understand what the problem is: complexity theory has matured over the past 3 decades & it has a number of valuable concepts to help economists understand their terrain better.

Most importantly in this context, complex systems are non-ergodic; which stands in contrast to orthodox economics, which treats the economy as ergodic. What this means in English is that an economy is continuously evolving, and that the future is inherently unknowable, and therefore uncertain. This point is particularly important for financial assets, which (in effect) attempt to map the future on to a contemporaneous market price. Neoclassical economics and the Efficient Markets Hypothesis (EMH) tend to view the economy like a machine, as if it had eternal laws and as if the future would be predictable if only we knew enough about it (as is the case with ergodic system). These points was covered well by both Eric Beinhocker in "The Origin of Wealth" and Richard Bronk in "The Romantic Economist".

If the future is inherently uncertain, there is no fundamental set of asset prices to which financial market prices will necessarily tend toward. Current public and market sentiment are highly influential in determining the current set of market prices, and the future evolution of the economy. But sentiment is subject to extreme shifts (known in complexity theory as bifurcation). This is the reality of financial markets, which is supported by our most advanced theory. Often the result seems to be poorly allocated resources, making bubbles and busts appear rather like inter-temporal collective action problems.

Why is this relevant to capital flows? Because in the West our social systems (including our institutions) are designed under the premise that the EMH is true: the market is assumed to deal perfectly with the free flow of capital within and between nations. But I am not aware of an argument that a non-ergodic system will produce optimal decisions about allocating savings to investment, spatially and inter-temporally.

I am not being prescriptive here e.g. I am not advocating wide-spread government intervention. I am merely saying that we do not understand very well what is going on because few economists (not none) are thinking about the economy as a complex system.

If you are interested, I have written a paper on the failure of EMH from the perspective of complexity theory, which includes discussions of non-ergodicity, the critical (and under-valued) role of sentiment, and some implications for policy.

atb | May 4 1:59pm | Permalink Report

Martin

I suppose this is the kind of rhetorical question for which economists are well known for. The answer, to me, seems rather obvious: the economic outcome of large capital inflows is really a function of the purpose to which these capital inflows were put to use for. If, for instance, these capital inflows went into investments in export producing industries, then it is more likely that the economic outcome will be a positive one. This is most likely the case of China, at least in the first 10-20 years of such inflows (it feels like some of this capital has gone into less productive investments lately, such as land speculation). The US in the 19th century also comes to mind. I understand that the UK may have also been the case, before the US, in the 17 and 18th centuries, although then not sure whether countries kept records of current accounts (I am referring to the capital that went into financing the East and West India Companies). It is when capital inflows go into unproductive investments or consumption that the economic outcome is most likely to end up in tears. Unfortunately, we have witnessed many such cases in the last 30-40 years, and these cases usually get a lot more attention from the press than the rosy outcomes.

jvcowan | May 4 2:16pm | Permalink Report

The problem is that producer countries are left with excess capital that they need to loan to consumer countries to allow them to continue buying from producer countries. It's a debt cycle.

There is no solution to this cycle, and it is caused by two main countries.

1. Germany. It is simply too productive. It cannot slow down to the pace of the rest of the world without a major cultural shift that may cause upheaval. The German government must loan to less productive countries so they continue to buy from Germany and keep the economy moving. It is absolutely fair to say that Germans simply work to hard and too efficiently.

2. China. It is too productive because of a dictatorship that does not encourage inefficient labour practises. It has

a mammoth population that are happy to work all day for a subsistance living. They cannot change this regime as they have not got a voice. The Chinese people are effectively permanent employees of a factory called China. All factories want a trade surplus!!

Regardless, countries cannot run a trade surplus or a trade deficit long term. The books must balance - but in our world they can't be made to balance. It is not possible. The question is how long this German/Chinese debt cycle can continue. Possibly for another few decades, possibly until the end of May. But one thing is for sure, the longer it goes on the bigger the disaster.

atb | May 4 2:17pm | Permalink Report

Oops, made some silly comments below. Obviously China is not a current account deficit country today, I was thinking of it about 20 years ago, before it cranked its export machinery, though I have to admit that I do not know whether it was then a current account deficit country then. Wonder whether Germany was in the same situation right after the War, though I would suspect that the capital for the rebuilding of German industry came in part from the Marshall Plan.

andrea colli | May 4 2:39pm | Permalink Report

A relevant example is provided by Europe during the Thirties, and basically Italy, which in the years after the first world war had an huge inflow of US capitals in some industries, as for instance in utilities. The crisis meant an immediate repatriation of US. capitals which deprived the Italian industry, almost overnight, of a relevant resource. In its turn this accelerated the dynamics of the crisis in Italy. This ituation can be labeled as "exceptional", but it is relevat to show the fact that huge inflows of foreign capital provides opportunities but also can accentuate structural fluctuations.

Equivocation | May 4 2:51pm | Permalink Report

Dear Martin,

I am glad to see that once more your analysis draws ever nearer to the Austrian School. Though you vehemently deny it, you will soon be a closet Austrian. I remember our first (and thus far only meeting) back in 2008 at the RSA conference with Lord Robert Skidelsky; you have come a long way. (By the way my regards to Robert I subsequently had the most interesting conversation with him on the Keynes-Hayek relationship).

Indeed, capital inflows that do not accompany productive investment are only inflationary. From a very real point of view it can be seen as foreigners coming in and buying tangible assets with paper currency. That is definitely not a good trade for emerging markets. Furtermore, this hot money feeds into asset price inflation throughout the entire emerging economy; very much what is happening in Brazil.

Imposing capital controls is a difficult subject to approach. We again have to determine what type of monetary system we will have. The ideal is again, biting the bullet now and reestablishing the asset backed monetary system. However, if political will is lacking we may have to continue with the fiat / fractional reserve monstrosity, If that is the case then certain controls would seem necessary to contain bubbles to manageable sizes (the Volker rule for example). Unfortunately, we must recognize that these controls will necessarily add inefficiencies to what would be a prosperous globalized society. The world will become a smaller place once more. Is that not a pity?

Best regards,

Equivocation

dafyddtaylor | May 4 3:05pm | Permalink Report

In theory, you can conceive of some sort of use for large amounts of imported capital in specific circumstances which would be economically useful.

In practice the sort of regulation required to ensure that imported capital is put to economically productive use would be sufficiently intrusive to send the capital elsewhere.

Sava Zxivanovich | May 4 3:08pm | Permalink Report

Capital inflow should be taxed according to its effect on the local population. Income increase is positive effect, price inflation (including properties) is negative.

For example, if the income of the local population increases 5% because of the inflow capital and the price of the houses/apartments increases 20%, the additional tax should be 15% because of the negative effect. Possible comments that the whole population benefits from increased "vapour wealth" may take a look at Ireland and Spain. The volatility of such "vapour wealth" is too big and the risk of loosing it too significant for it to be considered as a wealth at all.

Anthony Palmer | May 4 3:14pm | Permalink Report

Given the demographic differences between countries it would be very sad for everyone trying to build up or get hold of capital if a way can't be found to make capital travel more safely across borders.

My tuppenceworth is to point out that ownership across borders ought to be and tends to be safer than lending across borders as it doesn't involve a (potentially mispriced) transfer of risk. The dotcom bubble - an ownership bubble - burst much less painfully than the credit bubble.

So a good start might be to end the perverse life insurance and pension fund regulations that compel (UK anyway, don't know about elsewhere) entities to be in bonds.

A modern version of the risk sharing in islamic finance also looks good.

Not allowing people who lend across borders to book the profit until the principal as well as interest is repaid?

James Thornton | May 4 3:16pm | Permalink Report

To Mr. Fisher,

Your paper sounds interesting.. Let us know where to find it?

mcski | May 4 4:29pm | Permalink Report

Respectfully large capital inflows do not always end in crisis but they usually do if moral hazard takes hold.

Here is a simple way to see this. If a country has debt then there exists a greater chance of bankruptcy when forecasts turn sour. Greater debt equates to greater probability of bankruptcy around a sour forecast. When a country has savings there is virtually no chance of bankruptcy and the greater the savings the chance of bankruptcy is reduced further. Now the key to this concept is realize that forecasts do turn sour. There are periods of poor economic performance. There are periods where society is gripped with fear and these periods are more frequent when society has less confidence in government. Logic would dictate that greater debt would instill less confidence.

We also must admit that fat tales do exist and often in financial markets. We are in one now. Constantly using debt to stimulate economies virtually insures another collapse in times like these. It's time to pay back rather than extend and pretend.

Carlos Rovira | May 4 4:47pm | Permalink Report

Good question, Mr. Wolf. Trade imbalances are a major source of financial instability, but only one source. The problem with this kind of economic analysis is that it consolidates an entire economy into one node of a network. Instability ca be spotted only by looking at sectors inside that node, one key sectors goes and it make take the rest of the economy with it.

Inflows into a node clearly plant the seeds for bubbles, so they are dangerous. But crises can happen even in the face of large outflows, witness Japan since the late 80s. And financial instability can appear even with balanced flows. Bubbles are the exception not the rule of financial instability. So it's clear that this is not the whole picture.

Keynes' original design for the IMF as a negative feedback loop to stabilize the global system.

http://www.guardia...onal-monetary-fund

It is an interesting historical case, I think the only attempt to design an institutional solution to this problem.

The broader question is: what causes financial instability and how to avoid it? It has to be a network solution, the system is global now, you regulate one jurisdiction and the problem shows up in another and since all is interconnected a crisis in other jurisdictions can still hit you.

Bharat Kewalramani | May 4 5:15pm | Permalink Report

Not very difficult but not very free market. All inflows must be equity or local currency debt. Nothing allowed into real estate except when it is an incidental part of the investment (say a factory building) or an occupied home. Come a problem, the investor's demands will be reduced by lowered stock prices and a lower currency making it that much more likely they will hang in there; if not who cares. In at 2, out at .5, but the productive investment financed by the money stays in the country producing merrily away and bought at 75% off.

William Hooper | May 4 5:16pm | Permalink Report

Lets suppose that China continues to take manufacturing market share from the US, so the US-China imbalance continues. You mention four possible problems:

1. asset price bubbles in the US.
2. build-ups of private and public sector debt in the US
3. excessive leverage building up in the US
4. an excessively high dollar vulnerable to collapse

But 1-3 are short term effects that come out of the lag between the sudden capital inflow and efficient allocation? The next stage is a US recession and in the long term the US means of production ends up in the hands of the Chinese. This process continues until US voters rebel against "foreign exploitation" and renationalize.

The Bahamas would be one of the many historical examples. It also had that initial bubble after UK investors rushed to diversify there following the Attlee Government foreign exchange controls. But the Bahamas has never, and probably will never, restore competitiveness.

Greg J Fisher | May 4 5:18pm | Permalink Report

To James Thornton -

James, I don't know if the FT will allow me to put a url in here (Martin, please don't view this as a for of advertising) but here goes. Note it is not written for an academic audience as I wanted to capture a broader body of people.

www.pinnacleglobal.co.uk/emh

In any case, non-ergodicity was best captured by Ilya Progogine in "The End of Certainty"; and it is dealt with implicitly in Richard Bronk's excellent recent book "The Romantic Economist".

Ivana Bottini | May 4 5:54pm | Permalink Report

We have to get away from the idea that current account deficits are created by excess spending. A country can no more spend more than it earns than any one of us can. There is no magic process, no osmosis or gravitational force that drives money to where it is easier spent. The first thing, the most important thing is access to capital. Foreign capital inflows absolutely drive current account deficits. And the danger is that these flows are unregulated and volatile. In addition, of course, to the fact that foreign capital does not necessarily automatically and by magic end up allocated well in the country on the receiving end. The flood of money into Spanish property and into high-yileding Euroarea Government bonds being two cases in point.

The current Eurozone crisis and its resolution, which is centred around getting bond yields back down in previously high yielding countries at the expense of economic growth and with the use of dramatic 'austerity' programmes, should force us to look long and hard at why we allow foreign capital such easy and unregulated access. The idea seems to be that the Germans are 'virtuous' because they are unable to find investment opportunities at home. Why this should be seen as a virtue I do not know. Germany has exported capital, helped create bubbles and busts and then, to top it off, now demands 'austerity' from the countries where they directed their capital flows. The upshot being, of course, that capital exporters are allowed to export their living standards, or lack thereof, to everyone else. I'm not sure that this is not war by other means, or at least domination by other means.

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karenhelveg | May 4 5:55pm | Permalink Report

Maybe the question is wrongly put. Capitalism is crisis-bound, period. Nowadays this has been magnified by capital flows that have the spurious ability to create their own additional money. Why? Because the money is invested. If it is not invested and thus creating something more, it will lead to mere bubbles (the Asian crisis). If it is invested overseas, it will create real profits but at the behest of the domestic economy. The problem for the US related to its investments in China was simply that they led to decapitalization and increasing unemployment at home. So it was not the flows themselves but what they signified that was important. As a secondary phenomenon the flows and the repatriation of profits could for a long time mask the deep-seated problems because the profits were used to create more profits. This was the case with the subprime 'situation', which started as mortgages offered on lenient terms to people who could not until then afford house ownership and also to those who lost the income that should sustain them in their newly acquired houses.
The same with Greece but in a different fashion. Greece could not compete and suffered outflows. But because of the low interest rates this could be hidden for a long time (and here we are not talking about the 'assistance' proffered by Goldman Sachs doing God's work). So inflow - outflow, cha.
Next question: the nation state vs. the international economy. Here is a clear disconnect. As long as the nation state is the tax and welfare base plus offering a certain uniformity of conditions, there are bound to be escape clauses when borders are not sealed. If there was one state, there would still be differences and disequilibria of course.
And here we are not even thinking the material substance of economies into the equations. The mishaps and disasters that seem to occur with increasing frequency but without being captured theoretically.
But Mr. Wolf: the problem for the capital-importing countries is default if flows are not associated with 'real' investments. If the latter, they may still overheat unless they have efficient control mechanisms such as China. In other words, if short-term flows are intermediating real investment, the problem lies with the capital exporting countries' lower echelons. They are competing with the workers in the countries to which outsourcing goes. If the flows are just flimsy, chasing short-term profits, the problems lie with the importing countries. Simple as that.

Ivana Bottini | May 4 6:03pm | Permalink Report

And yes the answer is, if you don't want to see massive current account imbalances develop, then international capital flows must be regulated. Unfortunately we seem to have discovered this problem a bit late in the day. Now we must deal with the consequences of poorly thought out economic policies. It's back to Bretton Woods, or something to that effect, without the U.S. dollar as the sole international reserve currency. Unfortunately such reforms will be resisted until it becomes absolutely clear that there is no other way and that will probably take an economic disaster which we could be witnessing right now.

Adam Bartlett | May 4 6:15pm | Permalink Report

It would be ideal to reform international monetary system along the lines of Paul Davidsons IMCU plan (Bretton woods with a greater share of the burden for rebalancing born by surplus countries)

While waiting for the very special circumstances such a reform would require, small countries should use capital controls or forex intervention to check large inflows – the correlation with crises is too high to ignore, and while Chinas reserves are becoming too big for her to keep sterilising her surplus without risk of inflation, the same needn't be true for smaller economies.

Other policy options include to address the sources of debt at its source: - tax away savings from corporates which don't need them for imminent investment and use the revenue for social spending; act against downward pressure on wages; strengthen environmental regulation but relax about labour efficiency - together these things will reduce return on capital but will mean ordinary workers should have enough money support the level of demand needed to maintain a decent level of employment without further debt and hence additional imbalances.

Its inevitable that debt and imbalances will lead to a further expanded role for the state beyond that weve already enjoyed from the Keynesian resurgence, the questions are how quickly and to what degree states will collaborate or compete.

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henrye | May 4 6:46pm | Permalink Report

I just don't see the relationship between large capital inflows and "unsustainable build-ups of debt in the private and public sectors"? Granted these 2 can occur, but I just don't see the direct cause & effect.

Polospecialist | May 4 6:52pm | Permalink Report

I think this is a great discussion and I believe most points are completely valid. I would like to add the fact that as far as the situation in the United States is concerned, the current account deficits have been used to fund consumption. In addition, if you look at the budget deficit during the Bush Years you will also notice that this deficit was used primarily to fight a war. While I will agree that running large current account deficits (i.e. more than 5% as you suggest) is bad, running smaller deficits aren't necessarily a bad thing if you are investing in things that actually increase the productive capacity of a nation.

As far as the large fiscal stimulus in the United States is concerned, the idea was to invest in Infrastructure as a result of resurgence in Keynesian Economics (however, I believe Keynes was rolling in his grave as the Democrats used a misrepresentation of his ideals in order to get a stimulus bill passed). Unfortunately, we completely missed the mark and allowed Congress to just go out and patch a bunch of roads. I know that in New Jersey there was a project with New York to expand the tunnel system to allow more trains at one time which would alleviate congestion. Doing so would in theory have more people take public transportation and would make it so that those people along with those who already take public transportation would have a far higher likelihood of being on time to work thus increasing the productivity of each worker. Had we created an Infrastructure bank and made sure that projects followed this way of thinking I think the stimulus dollars would have been spent much more wisely. If you remember, projects of the New Deal followed this way of thinking.

Anyway, I appreciate the opportunity to comment and just to sum things up; I think it's important that we analyze not just the size of current account deficits, but also what they are being used to fund.

Munzoenix | May 4 7:49pm | Permalink Report

I absolutely agree that large capital inflows precede financial crisis, because most large capital inflows recently have been in the form of portfolio investments than foreign direct investments. It's important to differentiate between the two different types of capital inflows. Inflow of portfolio capital (into stocks and bonds) are very detrimental to the receiving-country. However, inflows of direct investments, into such things as factories, bridges, and other physical assets, is a good thing.

The Washington consensus in the past has supported the notion of capital mobility on the grounds of the latter. However in practice, foreign portfolio investments have become more significant It has gotten way too big since the fall of Bretton Woods with the size of global banks. Portfolio investments, because they can be liquidated very quickly, can cause severe market disruptions that does not allow receiving countries to adjust very quickly. By contrast foreign direct investments cannot be liquidated very quickly, and the longer planning horizon requires that when the investment is made it is meaningful (no such thing as making an investment and purposefully shorting it in underhanded activities). For example, Goldman Sachs can liquidate it's equity holdings in a Mexican factory very quickly, putting pressure on the company's balance sheet (maybe even forcing margin calls or collateral postings to back up certain liabilities; maybe even forcing the factory to make firesales on valid long-term investments so it can cover short-term liabilities). However, if Goldman Sachs made direct investments by building a factory in Mexico and some market disruption occurs, Goldman cannot liquidate the factory right away and have it "flee" to a safe haven like the United States.

China and India have clearly differentiated between the two forms of capital that are mobile, and therefore restrict foreign purchases of bonds and equity, while encouraging physical investments that cannot be repatriated right away. More importantly, such physical investments provide financially unquantifiable, but economically significant benets such as technological spillover in the receiving country and enhances that country to improve its ability to repay foreign obligations as they can produce something. And one thing I have learned in economics is that the more you produce, the more you can consume -- foreign portfolio inflows reduce production (not in theory, but in how it is currently practiced), while foreign direct investment increases production.

When a lender decides to give a loan to a borrower, the lender must decide if the borrower will have the ability to repay that loan in the future -- this is what is called "ability to repay." When there are large amounts of foreign portfolio investments, it causes the receiving country to experience a currency appreciation. Because relative prices are higher, it cripples exports -- thus, the country is producing less (and in the future, it will consume less). But, if there is capital inflows of foreign direct investments to build a factor, the currency will appreciate, too. However, the factory is more than likely going to raise productivity in the country, reducing costs, counteracting the increased cost from an initial appreciation.

And lastly, when there are capital movements, it should be towards poor nations. One thing about this crisis is that developed countries have to now "grow" out of this crisis. This is much harder to do than poor countries which can "grow" out of a crisis easier because there is more catch-up to do. What was unusual about this crisis was that poor countries were exporting capital to rich countries. Since $1 dollar of investment goes a longer way in a poor country than a rich country, and poor countries have a lot of needed catch up to do by investing in capital at home, the decision of these poor countries to export capital was a gross misallocation of resources, for which they should be held accountable. In particular, countries that have large reserves that are unjustifiable (Malaysia showed that during the Asian financial crisis, capital controls are far more powerful than having a warchest of foreign exchange reserves; thus to me, any significant reserves is unnecessary. All foreign portfolio investors should know that during a crisis, your investments may be held in "lock down" until further notice. It is a risk, but a far lower risk than the losses you'll suffer from the irrational exuberance and fear of the herd mentality).

Rich country banks did a poor job in not seeing how "undervalued" poor country fiscal investments were -- banks like Goldman Sachs should have taken the money coming from Asia to redirected it back to Asia by investing in fiscal assets in those countries. Instead, they invested in bad physical assets like subprime mortgages knowing they can short it and pass on the cost to someone else (AIG). This is misallocation of resources is something rich world banks should be held accountable for as well as the political institutions that allowed this to happen.

Having capital controls during extreme stress and restricting foreign investment to foreign direct investment (with significant controls on foreign portfolio investments) would go a long way to create financial stability -- this is all my opinion, off course.

Michael Pursey | May 4 7:59pm | Permalink Report

think what your analysis boils down to is that certain types of capital flows inevitably cause bubbles and subsequent their collapse. Speculation fuels and reinforces bubbles which, by distorting prices, encourage capital investment to be misallocated. Consequent collapses depend on the extent to which capital is misallocated throughout the economy.

The danger with capital inflows is that they are even more likely than domestic flows to be speculative across multiple asset classes while simultaneously masking bubbles. Indeed, the impact of currency appreciation on returns creates a feedback effect whereby risk can consistently be underpriced yet remain attractive to foreign capital, fuelling private sector deficits and domestic demand. All while the downward pressure of current account deficits on inflation helps create the illusion of stability and long term growth, thus hiding the effect of imbalances within the economy. Inflation targeting by central banks only serves to exacerbate the problem by keeping interest rates low. Hence speculative foreign capital encourages domestic capital to be misallocated throughout the economy and maintain the vicious cycle, followed by financial collapse.

But can capital inflows all be considered speculative? Some have characterised speculation as a form of capital alienation, whereby capital's primary use as an input to production is distorted by its potential capital returns. This for me is the key link. The delegation of capital allocation decisions in modern economies to a globalised financial services industry dominated by the EMH and accompanying CAPM provides the primary driver of capital alienation. Speculation and diversification become hard to distinguish when capital is alienated. As such, one of the main sources of capital inflows in a world of capital mobility is speculation. That developing economies seeking to contain capital inflows using exchange rates have avoided collapse is as much a lesson on speculation as a lesson on current account deficits.

AK | May 4 8:05pm | Permalink Report

It's an interesting (again poorly formulated) theoretical question raised at the end of the article -- though obscured by pointless discussion about current account deficit (as was intelligently shown above by Ms. Ivana Bottini that current account is closely tied with capital flows).

So, the question can be put as follows. As we've seen with Greece example the alternative to currency devaluation is only the country's default. Thus sovereignty over own currency is important tool in achieving sound and stable economic policy. And how can it be 'theoretically' related to ability of capital to flow globally over international borders?

I don't have ready 'theoretical solution' here though I was thinking rather briefly about this.

My gut feeling is that it is still possible though it would be rather instable solution (therefore one needs to insert some stabilizers there).

P.S. And I again agree with Ms. Ivana Bottini (her second post) that in current financial configuration it is rather impossible (so, it's a pleasure to meet here person who does really understand theoretical finance) though I don't agree with her suggestion about direct regulation of capital flows, which smells somewhat like a command-based (not a market-based) economic solution to me.
