

Financial  
Globalization:

# What to Think When Capital Flows Uphill

*By Eswar Prasad*

The torrent of funds crossing borders has been one of the most striking aspects of the recent wave of global financial integration. International capital flows have surged from just under \$2 trillion in 2000 to \$6.4 trillion in 2006.

It is a good thing, surely, to allow these vast sums to move to where they can be used most productively and to permit residents of each country to invest in a globally diverse range of assets. But a closer look reveals curious – and arguably problematic – aspects of the patterns of capital movement.

While poor and middle-income countries are receiving large sums of private capital, they are actually exporting more capital than they are getting. And since these emerging-market economies – those among the relatively poor countries that are reasonably



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well integrated into international financial markets – have less capital than industrialized countries to begin with, one would expect this backwash to be retarding their growth. Ironically, though, emerging-market economies are turning in fine growth performances – far better than those of industrial economies. Note, too, that we’re not talking about just China and India here: most emerging-market economies have been growing strongly since the beginning of the decade.

This strange reality is at the heart of an intensifying debate about the benefits and risks of financial globalization, a debate that has long aroused deep passions among academic economists, policymakers and social activists. Indeed, recent shocks to the global financial system – notably the unexpected magnitude of the spillover of America’s subprime-mortgage crisis – have reignited the debate about whether developing countries should expose themselves to the vagaries of international capital flows, especially if the benefits of such flows are chimerical.

Social activists are particularly riled that financial globalization seems to stack the deck in favor of industrialized countries and the rich and powerful in poor countries. And even setting aside considerations of fairness, there are basic questions about whether freer movement of capital is generating the benefits predicted by ivory tower economists and Wall Street’s new breed of financial engineers.

### **THE WORLD ACCORDING TO ECON 101**

Any analysis of the consequences of financial globalization requires us to think about what

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it is that capital flows could achieve in the best of circumstances.

Start with the common-sense notion that markets should funnel capital from rich countries to poor ones, since the returns on investments should be higher in developing countries brimming with cheap, underutilized labor. In addition, financial flows should allow for more efficient sharing of investment risk across countries. That is, the option to diversify asset holdings across the globe should allow individuals and corporations to insure themselves against unpredictable shocks that affect economies differently; the fortunes of, say, the German economy are not necessarily linked to those of China or Brazil or South Africa. To put it in the terms most familiar to economists, diversification should make it possible for investors from all countries to get higher returns for a given level of risk, or to reduce the level of risk needed to obtain a given expected rate of return.

Note, moreover, that these benefits should be greater for developing countries; they have less capital and more-volatile GDP growth, implying that they have both more metaphorical low-hanging fruit for investors to pick and a greater need for risk-minimizing diversification.

But the evidence that financial integration has accounted for systematically higher growth in developing economies is lacking. It is true that emerging-market economies have turned in much better growth performances on average than any other group in recent years. However, when the effects of other factors that also influence growth (domestic financial market development, containment of inflation, openness to trade, and the like) are accounted for, there is no evidence that financial integration has played an independent role in differentiating the winners from the losers.



By the same token, there is certainly no evidence that developing economies, or even the smaller group of emerging-market economies, have been better able than industrialized nations to buffer shocks to income through international portfolio diversification. Indeed, some observers have argued that financial integration has actually made businesses and investors in developing countries more vulnerable by exposing them to the full impact of global financial crises of the 1980s and 1990s. In other words, financial globalization may have created new risks without reducing the old ones!

And yet financial globalization has continued, with rising cross-border financial movement and with developing countries actively seeking to attract foreign capital. Not surprisingly, then, financial integration has become a hot policy issue, especially in countries like China and India where the pace of growth is forcing decisions about whether governments should make it easier for financial capital to flow across their borders or try to maintain

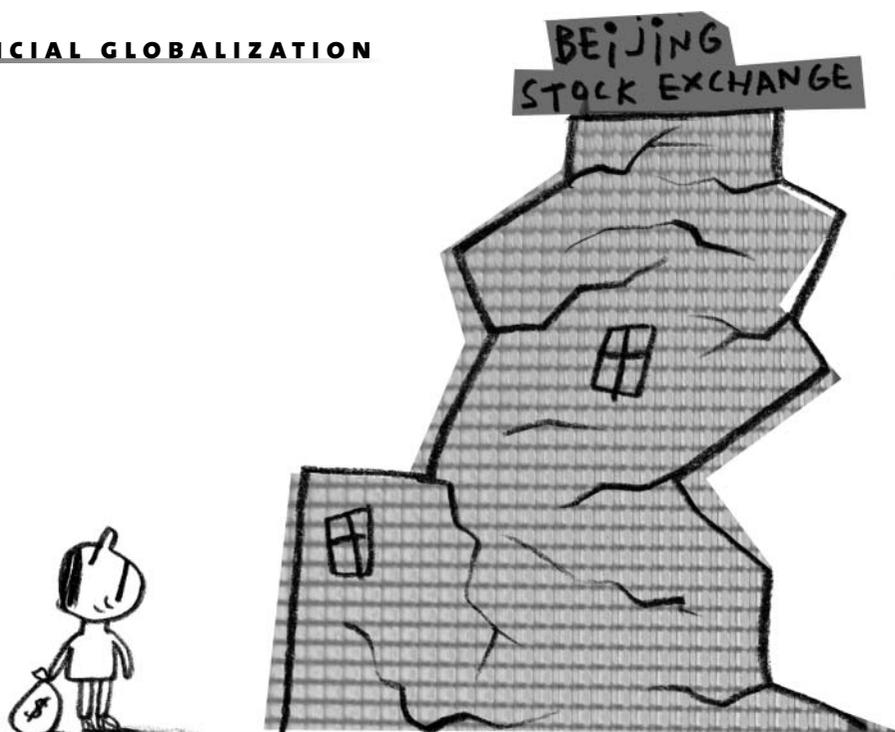
some degree of insulation from the consequences of financial integration.

#### **FOLLOWING THE MONEY**

As noted earlier, the puzzle underlying much of the discussion of global financial integration is the seemingly perverse direction of capital flows from poor to rich economies. It can't be explained by economic trauma – no financial crises have hit developing economies in particular during this decade. To add to the puzzle, among less-developed countries, more capital seems to go to slower-growing economies than to the faster-growing ones. Indeed, as a group, the stars of the development firmament have been net exporters of capital during this decade.

A large portion of the flows from developing to industrial economies is, of course, in the indirect form of government accumulation of foreign-currency reserves. When the Chinese government trades local currency for dollars earned by exporters selling honey or T-shirts or laptop computers and then holds the

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proceeds, the goal is not to pursue investment opportunities outside the country. But Beijing's motives (we'll get to them in a minute) should not be allowed to obscure the reality: China, and every other developing country accumulating dollar assets, is reducing the quantity of capital available for investment at home. And, on balance, this redirection of capital ought to be slowing the growth of countries in desperate need of everything from better highways to more electricity.

Oddly, though, both the recent strong performance of emerging-market economies (as well as the historical evidence) suggests that such "uphill" flows of capital do not adversely affect growth in developing economies. In fact, there is some evidence that developing countries importing less capital (that is, running larger current-account surpluses or smaller current-account deficits) tend to grow faster. In other words, countries that finance their domestic investment from their

own savings rather than relying on foreign capital have better outcomes. And this, in turn, suggests that a dearth of foreign financing for domestic investment is not an important factor holding back growth.

Why is it, though, that a reduced reliance on foreign capital is actually associated with *higher* growth among nonindustrial countries? One explanation is that the pattern of flows may reflect the weakness of the financial sectors in the capital-exporting developing countries. In economies like China that have high saving rates, the domestic financial system is not up to the job of allocating all of the domestic savings, let alone foreign savings, into productive investment.

So foreign financial capital (as distinct from the foreign technology and the business skills associated with direct nuts-and-bolts foreign investment) simply may not be of much use to such economies. Indeed, flows into economies with weak absorptive capac-

ity could even undermine growth by reducing the competitiveness of local enterprises in both foreign and domestic markets. As money flows into an economy and is traded for the local currency, it is natural that the price of the local currency increases – that is, the exchange rate appreciates. Such exchange-rate appreciation is particularly problematic for domestic manufacturing, which is more exposed to international competition. And the experience of countries ranging from 1960s Japan to 1980s Korea to 1990s China suggests that a strong manufacturing sector is a key to growth in developing economies.

Another possible explanation for the positive statistical correlation between current-account balances and economic growth is that domestic savings constitute a less volatile and more reliable source of financing for domestic investment. After all, domestic investors are less likely to take their capital out of the country on a whim – or, more to the point, for reasons unrelated to domestic economic prospects. Foreign investors, for example, may leave because of economic trauma back home or because of the pull of perceived investment opportunities elsewhere – say, real estate booms in Tokyo or Internet start-ups in Silicon Valley.

#### **ON THE OTHER HAND...**

All of this is not to say that financial integration has no discernible benefits. Indeed, there is accumulating (if only circumstantial) evidence that integration yields strong indirect benefits. Openness to foreign capital appears to catalyze the development of domestic financial markets, as well as to add to political pressure to improve the climate for modern enterprise. In India, the limited entry of foreign banks has already given domestic banks a much-needed kick in the backside, forcing them to improve their efficiency in order to

remain players. More generally, in countries open to foreign capital, domestic firms quickly learn that foreign investors tend to invest more in companies that have better corporate governance rules and more transparent accounting practices.

Easing restrictions on cross-border capital flows can also serve as a way to discipline domestic policymakers. If a country opens its doors to international financial flows and then runs loose monetary or fiscal policies that lead to high inflation or large government deficits, foreign investors are more likely

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to turn tail at the slightest hint of trouble. Countries that have sound macroeconomic policies, by contrast, are less likely to lose investor confidence so easily. Thus, financial integration serves as an incentive for leaders to stick with growth-enhancing policies.

By the same token, making it easier to gain access to international capital markets gives domestic investors an opportunity to diversify their portfolios. This means greater competition for domestic financial institutions. But it also creates opportunities for them to cultivate the savvy to offer products that help

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their customers invest abroad. And these collateral benefits may prove to be even more important to productivity growth in the long run than access to foreign capital.

But here, too, there is a complication: at the beginning of the process of integration, the collateral benefits are elusive and the risks are more difficult to manage. For instance, in an economy with an underdeveloped financial system, openness increases vulnerability to hazards ranging from fraud to liquidity problems. Integration is also more problematic in countries with unstable macroeconomic policies, high levels of corruption, a low degree of openness in trade and poorly designed, poorly executed regulation. Indeed, a primary lesson of the 1997 Asian financial crisis is that easy access to foreign capital compounds the adverse consequences of crony capitalism.

The benefits of financial integration are clearly evident only when financial systems and institutions reach the level of development typically seen in advanced industrial economies. This creates a conundrum for poor countries that rightly view integration as a way to speed the development of a sophisticated domestic financial system, but cannot afford the risks en route.

These threshold effects are also relevant in realizing the potential benefits of diversifying investment risk. One reason: access to international financial markets is often only available in boom times, implying that investors lose the option of external financing just when they need it the most.

The fact that financial integration yields powerful indirect benefits in the long run but can exacerbate economic problems in the short has important implications. Countries like China that are in the process of easing restrictions on capital flows may be building a

vast cushion of international reserves as a means of protecting their economies from mishap – a trillion and a half dollars in the central bank and the willingness to use it could go a long way toward preventing panic during a financial crisis. Thus, the strategy of running big current-account surpluses may permit developing countries to proceed down the path of financial integration without fully exposing themselves to the transitional risks associated with volatile capital flows.

### **WHEN IMBALANCES MAY (OR MAY NOT) BE VIRTUOUS**

Large current-account deficits in some industrial countries (notably the United States), mirrored by large surpluses in emerging-market economies are now referred to rather ominously as global imbalances. Indeed, a growing chorus of analysts is predicting that massive exchange-rate adjustments will be needed among the key economies – China, the United States, Japan, Britain, the Eurozone – in order to correct these imbalances.

We have already seen substantial realignments of exchange rates, with the dollar in particular depreciating against the other major currencies. And yet, large current-account imbalances remain. Most strikingly, China registered a current-account surplus of almost 12 percent of GDP in 2007.

Even if these imbalances turn out to be sustainable in the sense that they dissipate relatively smoothly in future years, it is worth considering the social implications of using the savings of Chinese (and Taiwanese and Saudis) to finance the consumption of Americans. Or, more precisely, it is worth considering the ongoing societal costs associated with maintaining these imbalances.

As exhibit A, consider China, which has built massive foreign-exchange reserves in recent years. This buildup has been the result

of trying to sustain a stable exchange rate between China's renminbi and the dollar even in the face of strong economic pressures for appreciation. Given China's strong productivity growth, it is natural that the renminbi would tend to appreciate. To prevent this appreciation, and to avoid any loss of export competitiveness, the People's Bank of China (the Chinese central bank) has been buying dollars and selling renminbi at a furious clip. Consequently, Chinese foreign-exchange reserves now stand at well over \$1.5 trillion – an unprecedented amount in any country's history.

The maintenance of the exchange rate has not, however, been without costs for China. Most important, it has complicated domestic macroeconomic management. China's controls on private exchanges of renminbi for other currencies are moderately effective, but hardly airtight.

Thus, in focusing on exchange-rate stabilization, China has largely ceded the ability to use monetary policy to target domestic objectives like controlling inflation. For example, raising interest rates to control runaway investment growth financed by bank credit could induce even more capital to flow into the economy. That's because higher rates would make Chinese financial assets even more attractive.

Hence, while the mountain of foreign-exchange reserves may serve as a useful cushion against both external shocks and instabilities associated with China's dilapidated banking system, the financial repression that has sustained the fixed-exchange-rate regime may have longer-lasting consequences. In particular, the lack of an independent monetary policy has further hindered the already difficult process of financial reforms by forcing China's central bank to rely on improvised policy actions – including jawboning and quantitative restrictions on credit – rather

than market instruments like interest rates to control the growth of lending. This is clearly not good for the larger objective of getting the banks to learn how to respond effectively to market signals rather than to orders from the government.

Note, too, that even if countries now deliberately building foreign-exchange reserves decided to mend their ways, current-account imbalances may be slow to change. Consider China once again. Removing the burden of maintaining the exchange value of the renminbi could trigger a virtuous cycle that speeded financial sector reform and sharply reduced the level of wasteful investment that now absorbs so much of China's savings. And if, as a result, the demand for investment declined in the short run, the current-account surplus would in fact increase.

#### **MAKING SENSE OF THE CHINA SYNDROME**

In an ideal world, relatively capital-poor economies would have better financial systems that would allow them to channel both domestic savings and foreign capital to their most productive uses, in the process stimulating economic growth and strengthening financial institutions. By the same token, rich countries would generate surpluses to finance lucrative investments in capital-poor economies rather than absorbing poor-country savings to finance their own consumption.

But this isn't an ideal world. And rather than asking whether "uphill" capital flows reflect irrational behavior, it would be useful to ask what these seemingly perverse international financial flows are signaling about more basic problems in the institutions buttressing the world economy.

Whether or not global imbalances are destined to end with a bang, they are a sign of things gone awry. **M**