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RETHINKING DEVELOPMENT ECONOMICS

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INTERNATIONAL PRIVATE CAPITAL FLOWS AND DEVELOPING COUNTRIES

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1. Introduction

Since the mid-1990s, financial crises have plagued developing countries, including Mexico, South Korea, Thailand, Indonesia, the Philippines, Malaysia, Russia, Brazil, Turkey, Argentina and Uruguay. Several of these had been identified as 'model economies' by the international investment and multilateral communities in the years preceding crisis.

When confronted with the challenge of explaining how so many model economies could morph into basket cases in such a short period of time, neoclassical economists sought refuge in defensive explanations of these crises. Each new crisis stimulated research that explained the relevant country's implosion as the outcome of deeply rooted - but apparently overlooked - problems of cronyism, corruption, malfeasance, unsustainable speculative bubbles and/or ill-conceived programs of state intervention. In work on the Mexican, Asian and Argentinean crises, I term these efforts 'exceptionalist' accounts of crisis.

Along with other heterodox (especially post-Keynesian) economists, I unequivocally reject exceptionalist accounts of the recent crises. In my view, the principal cause of these financial crises is the decision to adopt policies of financial liberalization, a strategy that is known as neoliberal financial reform. Programs of neoliberal financial reform have many components, the most important of which is the removal or loosening of restrictions on domestic and international flows of capital. There were, of course, differences in the degree of neoliberal financial reform among the countries that faced crisis, but it nevertheless played a central causal role in each. In particular, the liberalization of international private capital flows (IPCFs) - especially the most liquid
and short-term of these - created and/or aggravated the vulnerabilities that culminated in crises. The heterodox view of unregulated IPCFs articulated here stands in sharp contrast to the dominant neoclassical theory of the developmental benefits of these flows. Given the largely sceptical stance toward unregulated IPCFs, the heterodox view naturally calls for significant changes in the governance of these flows. In this chapter I articulate the heterodox view of liberalized IPCFs in contradistinction to the dominant neoclassical view.

2. Terminology

International capital flows consist of public and private flows. Bilateral (public) flows involve transfers of capital in the form of loans or foreign aid between governments; multilateral (public) flows involve transfers of capital between multilateral institutions such as the IMF or the Asian Development Bank and governments. There are four main types of IPCFs: remittances, foreign bank lending, portfolio investment (hereafter PI) and foreign direct investment (hereafter FDI). Private remittances refer to international capital transfers between individuals. The most common type of private remittance occurs when a person working abroad sends funds to a family member in the home country. Foreign bank lending refers to the loans extended by commercial banks or multilateral institutions to domestic public or private sector borrowers. PI refers to the purchase of stocks, bonds, derivatives and other financial instruments issued by the private or public sector in a country other than one in which the purchaser resides. FDI refers to the purchase of a "controlling interest" (defined as at least 10% of the assets) in a business in a country other than one in which the investor resides.

3. Empirical trends

There are two key trends in IPCFs that should be noted.

3.1 Trend 1: during the 1990s the importance of private flows increased, and PI and FDI became important components of IPCFs

During the 1990s, there was an increase in the relative importance of private, as opposed to public, capital flows. In this period, many donor governments reduced their foreign aid flows in the context of changes in domestic political sentiments on aid.

At the same time that IPCFs were increasing in importance relative to public flows, the composition of IPCFs was changing as well. Historically, foreign lending by commercial banks was the most significant type of IPCF to developing countries. But during the 1990s, commercial banks curtailed this lending. The reduction in lending stemmed from two developments. Commercial banks became wary of lending to developing countries following the "debt crisis" of the 1980s (although the largest banks were able to pass on the costs of these loans through various publicly-financed initiatives). Banks also found the speculative opportunities available in the liberalized financial environment of the 1990s far more appealing than lending. The decline in both foreign lending and aid to developing countries in the 1990s elevated the importance of attracting FDI and PI flows, both of which increased significantly during this period.

These fundamental changes in the composition of IPCFs to developing countries are illustrated in the following data. The net flow of long-term bank lending (including bonds and excluding loans extended by the IMF) to developing countries was $US 7 billion in 1970, $65.3 billion in 1980, $43.1 billion in 1990, $13.6 billion in 2000 and $-19.5 billion in 2001. In contrast, net FDI to developing countries was $2.2 billion in 1970, $4.4 billion in 1980, $24.1 billion in 1990, $166.7 billion in 2000 and $168.2 billion in 2001. Net PI grew dramatically during the 1990s as well: it was 0 in 1970 and 1980, $3.7 billion in 1990, $50.9 billion in 2000 and $18.3 billion in 2001.

3.2 Trend 2: despite growth in PI and FDI to developing countries, their share of global flows is rather small and remains highly concentrated in large, middle-income countries

The aggregate figures presented above illustrate key changes in the composition of IPCFs to developing countries during the 1990s. However, these data do not reveal two important facts. Developing countries receive a very small proportion of global IPCFs; and IPCFs are highly concentrated in a small number of middle-income, large developing countries. Thus, despite the changes in IPCFs to developing countries since the 1990s, the fact remains that their share of global PI flows remains rather low. Developing countries received 9.7% of global PI flows in 1991, 9.0% in 1994, 6.2% in 1998 and 5.3% in 2000.

The picture for FDI is somewhat brighter: developing countries received 22.3% of global FDI in 1991, 35.2% in 1994, 25.9% in 1998 and 15.9% in 2000. FDI flows to developing countries, however, are highly concentrated in roughly ten large, middle-income countries. During the period 1991-2000, the top ten recipients of FDI flows were (in descending order of importance)
China, Brazil, Mexico, Argentina, Malaysia, Poland, Chile, South Korea, Thailand and Venezuela. These ten countries received 74% of the FDI flows that went to the developing world in 2000. By contrast, low-income developing countries receive a very small amount of IPCFs. Low-income developing countries received $0.3 billion of net FDI in 1970, $0.2 billion in 1980, $2.2 billion in 1990, $9.7 billion in 2000 and $8.6 billion in 2001; they received no PI in 1970 and 1980, $0.4 billion in 1990, $2.6 billion in 2000 and $2.5 billion in 2001.1

Despite unevenness in the distribution of IPCFs, and despite the small share of global IPCFs that actually accrue to developing countries, neoclassical economists maintain that policy must target the attraction of these flows via the creation of open, liberalized markets (and other reforms).

### 4. Factors driving IPCFs

The growth in FDI and PI flows to developing countries since the 1990s is driven by the interaction of numerous factors.7

From the late 1980s onward, money managers in industrialized countries found new opportunities for profitable investments, especially for short-term speculative investments, in the liberalizing financial markets of developing countries. The speculative boom in these markets and the new opportunities presented by privatization and mergers and acquisition activities made both FDI and PI desirable.

The liberalization of IPCFs in developing economies created a self-perpetuating dynamic. Liberalization often led to new inflows and increases in asset prices, a phenomenon that led to further liberalization and asset price inflation. Policymakers in developing countries were eager to take advantage of this dynamic, especially since public capital flows and private bank lending to many countries were being curtailed.

Powerful actors like the US government and the IMF have not hesitated to use material and political capital to press developing countries to liberalize IPCFs. US administrations (from Clinton to Bush II) have conditioned entrance to international organizations like the WTO and the OECD, and international and bilateral trade agreements on developing economies' willingness to implement neoliberal financial reforms.8 The IMF deserves special mention for its efforts to compel countries to liberalize IPCFs (along with the rest of their economy) as a precondition for financial assistance.

The financial and business communities in both developing and industrialized countries have also actively promoted the liberalization of IPCFs. In addition to the obvious material rewards that accrue to proponents of liberalization, its advocates are also driven by ideological considerations. Speci-

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**5. Neoclassical theory: the benefits of unregulated IPCFs**

Neoclassical economic theory makes a rather straightforward case for the developmental benefits of unfettered IPCFs.9

#### 5.1 The positive case for liberalizing IPCFs

Unrestricted IPCFs give the public and private sectors in developing countries access to capital and other resources (such as technology) that are not being generated domestically because of low income, low savings, low growth and/or capital flight. Thus, inflows of international private capital will increase the nation's capital stock, productivity, economic growth and income. Domestic resources are also inadequate to the task of financing public expenditure because of problems with tax collection and the myriad demands placed on government budgets. Sales of government bonds to foreign investors also increase the resources available for public expenditure.

In addition to inaugurating a virtuous cycle of capital inflows and economic growth, neoclassical theory maintains that IPCFs can increase efficiency and policy discipline in developing countries. The need to attract IPCFs and the threat of capital flight (by domestic and/or foreign investors) are powerful incentives for the government and firms to maintain international standards for policy design, macroeconomic performance and corporate governance. For example, governments that seek to attract IPCFs will be more likely to pursue anti-inflationary economic policies and anti-corruption measures because investors place a high value on price stability and transparency.

Moreover, the liberalization of IPCFs means that these flows will be allocated by markets rather than by governments. According to neoclassical theory, this shift in the allocation mechanism increases efficiency and ensures that finance will be directed towards those projects that promise the greatest net contribution to social welfare. These, of course, will be the projects promising the highest rates of return.

Given this range of developmental benefits, it is not difficult to comprehend the zeal with which neoclassical theorists promote the liberalization of IPCFs. Indeed, had the Asian financial crisis not intervened, the IMF was poised to modify Article 8 of its Articles of Agreement to make the liberalization of all IPCFs a central purpose of the Fund, and to extend its jurisdiction to capital movements.10
5.2 The debate over sequencing

A small number of neoclassical economists hold a more nuanced view regarding the liberalization of IPCFs. Some neoclassicals argue that the liberalization of IPCFs should be undertaken only after successful liberalization of other sectors of the economy (such as the industrial sector), appropriate institution building and/or attainment of a minimal degree of financial development. This is known as the ‘sequencing’ argument. Advocates of sequencing generally find their case strengthened following financial crises, as these are seen as a consequence of premature financial liberalization.

It is important to recognize that even among those neoclassical economists who advocate sequencing there is no question that the liberalization of IPCFs remains the ultimate goal for all developing countries. Moreover, the case for sequencing is controversial, even within neoclassical theory. Some neoclassical political economists reject the case for sequencing on the grounds that it introduces problems (such as corruption, inertia in reform, slow growth, high capital costs) that are far worse than any financial instability associated with the liberalization of IPCFs.

6. Heterodox theory: the problems with unregulated IPCFs

The neoclassical case for unfettered IPCFs falls on both theoretical and empirical grounds. The liberalization of IPCFs creates a vulnerability to financial crisis, and introduces five distinct, mutually-reinforcing risks to developing economies. These are currency, flight, fragility, contagion and sovereignty risk. The liberalization of all IPCFs is associated with these five problems, albeit to different degrees and through different means.

6.1 Currency risk

Under a system of floating exchange rates, large, sudden inflows of capital can put pressure on the domestic currency to appreciate. A large appreciation of the domestic currency is problematic because it can undermine net export performance. Alternatively, large, sudden capital outflows (termed ‘capital flight’) can place pressure on the domestic currency to depreciate. This risk of currency collapse is an attribute of any type of exchange-rate regime, provided the government maintains full currency convertibility. Events in Asia and Argentina have underscored the fact that pegging a currency (even through a currency board) does not eliminate currency risk.

Developing economies confront the greatest currency risk for two reasons. Governments are unlikely to hold sufficient reserves to protect the value of their currency should they confront a generalized investor exit. An initial exit from the currency is therefore likely to trigger a panic that deepens investors’ concerns about reserve adequacy. Moreover, governments in developing economies are rarely able to orchestrate multilateral currency rescues.

6.2 Flight risk

Flight risk refers to the likelihood that, in the face of perceived difficulty, holders of liquid financial assets will sell their holdings en masse. Capital flight often induces a vicious cycle of additional flight and currency depreciation, debt-servicing difficulties and reductions in stock (or other asset) values. This is because panicked investors tend to sell their assets en masse to avoid the new capital losses brought about by anticipated future depreciations of currency or asset values. In this manner, capital flight introduces or aggravates existing macroeconomic vulnerabilities and financial instability.

Developing economies face acute flight risk because of the likelihood of investor and lender herding. In this context, investors face greater political and economic risks and are less confident about the information they receive. Moreover, since investors and lenders often fail to differentiate among developing economies, these economies are more vulnerable to generalized investor and lender exits. Flight risk is most severe when governments fail to restrict the kinds of IPCFs that are subject to rapid reversal (namely, PI, short-term foreign loans and liquid forms of FDI).

6.3 Fragility risk

Fragility risk refers to the vulnerability of an economy’s private and public borrowers to internal or external shocks that jeopardize their ability to meet current obligations. Fragility risk arises in a number of ways. Borrowers might finance long-term obligations with short-term credit, causing ‘maturity mismatch’ (or what Minsky called ‘Ponzi financing’). This leaves borrowers vulnerable to changes in the supply of credit, thereby exacerbating the ambient risk level in the economy. Borrowers might contract debts that are repayable in foreign currency, causing ‘locational mismatch.’ This leaves borrowers vulnerable to currency depreciation that may frustrate debt repayment. Agents might finance private investment with capital that is prone to flight risk. Investors (domestic and foreign) may overinvest in certain sectors, thereby creating overcapacity and fuelling unsustainable speculative bubbles.

To some extent, fragility risk is unavoidable. But the degree to which the decisions of economic actors induce fragility risk depends very much on whether the institutional and regulatory climate allows the adoption of risky
strategies. If regulatory bodies do not seek to coordinate the volume, allocation and/or prudence of lending and investing decisions, then there will exist no mechanisms to dampen maturity or location mismatches, or the impulse to overborrow, overleverage or overinvest. Financial integration magnifies the possibilities for over-exuberance (and introduces currency-induced fragility) by providing domestic agents with access to external sources of finance in the form of IPCFs.

6.4 Contagion risk

Contagion risk refers to the danger of a country falling victim to financial and macroeconomic instability that originates elsewhere. While financial integration is the carrier of contagion risk, its severity depends on the extent of currency, flight and fragility risk that characterise the economy. Countries can reduce their contagion risk by managing their degree of financial integration and by reducing their vulnerability to currency, flight and fragility risks through a variety of financial controls.

6.5 Sovereignty risk

Sovereignty risk refers to the danger that a government will face constraints on its ability to pursue independent economic and social policies. Unregulated IPCFs increase the influence of domestic and foreign investors over domestic policymaking and raise the spectre of excessive foreign control or ownership of domestic resources.

The four risks discussed above can culminate in a financial crisis, an event that seriously compromises economic performance and living standards (particularly for the poor) and often provides a channel for undue foreign influence over domestic decisionmaking. This influence may be exercised in a number of different ways. Policymakers in developing countries may believe that it is necessary to pursue particularly contractionary economic policy during financial crises in order to rescue a collapsing currency and slow investor flight. Moreover, following a crisis, an especially contractionary policy regime may be deemed necessary in order to induce investors to return to the country. And assistance from the IMF following financial crises comes at the price of having critical domestic policy decisions vetted by the institution.

Although sovereignty risk stems from the structural position of developing countries in the world economy, this does not imply that the risk is unmanageable. The adoption of measures to constrain currency, flight, fragility and contagion risk all render the possibility of financial crisis less likely (or reduce its severity should it occur), and thereby buttress policy sovereignty.

6.6 Summary and empirical findings

The five risks discussed above are deeply interrelated and mutually reinforcing. Analytically, the key point is that the liberalization of IPCFs in developing countries introduces a constellation of risks. The precise triggering mechanism of any individual crisis is ultimately unimportant and usually unpredictable. Similarly, the exceptional features of a particular country do not themselves induce a vulnerability to crisis. Vulnerability is created instead by the specific and interacting risks induced by the liberalization of IPCFs.

Are the rewards of financial liberalization worth the price of exacerbated risk? To date, there exists no unambiguous cross-country or historical evidence that the liberalization of IPCFs is economically beneficial to developing countries. Numerous recent cross-country and historical studies demonstrate conclusively that there is no reliable empirical relationship between the liberalization of IPCFs in developing countries and performance in regards to inflation, economic growth or investment. More damaging to the neoclassical case is the fact that there is now a large body of unambiguous empirical evidence which shows that the liberalization of IPCFs introduces and/or aggravates important problems in developing countries. For example, numerous studies find that liberalization is strongly associated with banking, currency and generalized financial crisis. Other studies show that liberalization is associated with an increase in poverty and inequality.

7. The necessity of controls on IPCFs

In view of the arguments advanced above and empirical evidence provided (above and below), I argue that there is a strong case for controlling IPCFs in developing countries. Well-designed controls over IPCFs can achieve – and in many cases have achieved – some or all of the following three objectives. First, capital controls can promote financial stability and thereby prevent the economic and social devastation associated with financial crises. Second, capital controls can promote desirable types of investment and financing arrangements (e.g., long-term, stable and sustainable arrangements, which create employment opportunities, improve living standards, promote income equality, technology transfer and learning-by-doing) and discourage less desirable types of investment/financing strategies. Third, capital controls can enhance democracy and national policy autonomy by reducing the potential for speculators and various external actors to exercise undue influence over domestic decisionmaking and/or control over national resources.

Capital controls refer to measures that manage the volume, composition, or allocation of capital flows and/or maintenance of restrictions on investor
exit or entrance opportunities. Nearly all industrialized countries successfully utilized capital controls for long periods of time. For example, continental European countries employed extensive capital controls during the economic reconstruction that followed World War II.

Capital controls played critically important roles during the high-growth eras of Japan and most of the 'Asian tiger' economies. Capital controls were successfully employed in Brazil in the 1950s and 1960s, Chile and Colombia successfully used capital controls during the 1990s. The Malaysian government successfully employed stringent capital controls in 1994 and 1998. Despite the fact that capital controls have fallen out of favour as a consequence of the hegemony of neoclassical views and other factors discussed in section 4 above, some economically successful countries such as China and India continue to employ extensive controls over a variety of investment and financial activities.

8. Strategies for Controlling IPCFs

I now present examples of three broad approaches to controlling IPCFs. These are: ‘trip wires’ and ‘speed bumps’; the ‘Chilean model’; and restrictions on currency convertibility. These measures differ from one another in two respects: according to their tangency with market principles and their degree of permanence (i.e., whether they are to be in place prior to signs of distress, or whether they are activated as needed).

8.1 ‘Trip wires’ and ‘speed bumps’

The trip wire–speed bump approach is designed to target the unique risks to which individual countries are most vulnerable, and to prevent these risks from culminating in a financial crisis. Trip wires are simple measures that warn policymakers and investors that a country is approaching high levels of currency risk, investor and lender flight risk and fragility risk. When a trip wire indicates that a country is approaching trouble, policymakers could then immediately take steps to prevent crisis by activating speed bumps. Speed bumps would target the type of risk that is developing with a graduated series of mitigation measures.

Developing economies at the lowest, middle and highest levels of development might require distinct trip wire thresholds. Trip wires must be appropriately sensitive to subtle changes in the risk environment, and adjustable. Sensitive trip wires would allow policymakers to activate graduated speed bumps at the earliest sign of heightened risk well before conditions for investor panic had materialized.
next. From this perspective, warnings of potential danger must be coupled with restrictions on investor behavior—otherwise, the warnings are apt to induce the very crisis that they are designed to prevent.21

8.1.1 Effect on risks

Trip wires could indicate to policymakers and investors if and when a country approached high levels of currency, fragility and flight risk. The speed bump mechanism provides policymakers with a means to manage measurable risks, thereby reducing the possibility that policy sovereignty will be constrained by a financial crisis. Those countries that have trip wires and speed bumps in place are also less vulnerable to contagion effects from crises that originate elsewhere. Hence, the combined effect of trip wires and speed bumps is to reduce the likelihood of currency, flight, fragility, or contagion risk sparking full-blown economic crisis.

It is certainly possible that activation of trip wires in one country could aggravate contagion risk in those countries that investors have reason to perceive as being vulnerable to similar difficulties. This risk could be mitigated through the use of ‘contagion’ trip wires. These would be activated (in ‘country B’) whenever speed bumps are implemented in a country that investors have reason to view similarly (‘country A’). In such circumstances, country B would then implement appropriate speed bumps.

One complication bears mention: at present, off-balance sheet activities such as derivatives are largely non-transparent. Recent research indicates that these transactions played a significant role in the Asian crisis.22 The trip wire—speed bump approach requires that actors be compelled to disclose these activities. In the absence of the will to enforce transparency, policymakers in developing countries would be well advised to forbid domestic actors from engaging in off-balance sheet activities.

8.1.2 A digression on Malaysian controls, 1994 and 1998

In the context of astounding increases in capital inflows, Malaysian authorities implemented stringent, temporary inflow controls in early 1994. Reaction to these measures was rapid and dramatic, so much so that authorities were able to dismantle them in under a year. During the period that the controls were in place, the volume of net private capital inflows and short-term inflows was reduced severely (falling by 18 and 13 percentage points of GDP respectively), the composition of these flows was altered significantly and the inflation of stock and real estate prices was curtailed.23

The Malaysian government again implemented stringent controls over capital inflows and outflows in 1996, in the context of the Asian crisis. The government responded to the crisis by restricting foreigners’ access to the domestic currency via restrictions on bank lending and account maintenance, and by declaring currency held outside the country inconvertible, by fixing the value of the domestic currency and restricting international transfer and trading of the currency, by closing the secondary market in equities and by prohibiting non-residents from selling local equities held for less than one year. According to numerous accounts, these rather stringent measures achieved their basic objectives.24 They stabilized the currency and the stock market; facilitated the recovery of employment, wages and the broader economy; and enabled the government to pursue relatively autonomous policy. The immediate, powerful reaction to the temporary Malaysian controls in 1994 and 1998 underscores the potential of speed bumps to target incipient difficulties.

8.2 The ‘Chilean model’

In the aftermath of the Asian crisis, heterodox and even prominent mainstream economists focused a great deal of attention on the ‘Chilean model,’ a term which refers to a policy regime that Chilean and Colombian authorities began to implement in June 1991 and September 1993 respectively. The backdrop for this policy regime in Chile was an ambitious program of neoliberal reform. Though there were national differences in policy design, Chilean and Colombian policies shared the same objectives. The policy regime sought to balance the challenges and opportunities of financial integration, lengthen the maturity structure and stabilize capital inflows, mitigate the effect of large volumes of inflows on the exchange rate and exports and protect the economy from the instability associated with speculative excess and the sudden withdrawal of external finance.

8.2.1 Chile, 1991–8

Financial integration in Chile was regulated through a number of complementary measures. From June 1991 through early 2000, authorities maintained an exchange rate band that was gradually widened and was modestly revalued several times. The monetary effects of the rapid accumulation of international reserves were also largely sterilized. The only policy that governed capital outflows by Chilean investors was a provision that pension funds could invest a maximum of 12% of their assets abroad.

Central to the success of the Chilean model was a multifaceted program of inflows management. Foreign loans faced a tax of 1.2% per year. FDI and PI...
faced a one-year residence requirement. And from May 1992 to October 1998, Chilean authorities imposed a non-interest bearing reserve requirement of 30% on all types of external credits and all foreign financial investments in the country. The required reserves were held at the Central Bank for one year, regardless of the maturity of the obligation.

The Central Bank eliminated the management of inflows (and other financial controls) in several steps, beginning in September 1998. This decision was taken because the country confronted a radical reduction in inflows in the post-Asian crisis environment (rendering flight risk not immediately relevant). Chilean authorities determined that the attraction of IPCFs was a regrettable necessity in light of declining copper prices and a rising current account deficit. Critics of the Chilean model heralded its demise as proof of its failure.

But others viewed the dismantling of the model as evidence of its success insofar as the economy had outgrown the need for protections. For example, Eichengreen notes that by the summer of 1998 it was no longer necessary to provide disincentives to foreign funding because the Chilean banking system was on such strong footing. In my view, the decision to terminate inflows management was imprudent, given the substantial risks of a future increase in IPCFs to the country, and the risk that the country could experience contagion from financial instability in Argentina, Brazil, Paraguay and Uruguay. It would have been far more desirable to maintain the controls at a low level while addressing the current account deficit and the need to attract inflows through other means. Indeed, flexible deployment of the inflows policy was a hallmark of the Chilean model (consistent with trip wires—speed bumps), and it is regrettable that authorities abandoned such a successful strategy.

8.2.2 Colombia, 1993-8

Colombia's inflows management policies relating to foreign borrowing were similar to (though blunter than) those in Chile. Beginning in September 1993, the Central Bank required that non-interest bearing reserves of 47% be held for one year against foreign loans with maturities of eighteen months or less (this was extended to loans with a maturity of up to five years in August 1994). Foreign borrowing related to real estate was prohibited. Moreover, foreigners were simply precluded from purchasing debt instruments and corporate equity (there were no comparable restrictions on FDI). Colombian policy also sought to discourage the accretion of external obligations in the form of import payments by increasing the cost of import financing. Authorities experimented with a variety of measures to protect exports from currency appreciation induced by inflows. As in Chile, regulations on IPCFs were gradually phased out following the Asian crisis.

8.2.3 Effect on risks

The Chilean model represents a highly effective means for managing all of the risks under consideration here. Numerous empirical studies find that inflows management in Chile and Colombia played a constructive role in changing the composition and maturity structure (though not the volume) of net capital inflows, particularly after the controls were strengthened in 1994-5. These studies also find that leakages from these regulations had no macroeconomic significance. Following implementation of these policies in both countries, the maturity structure of foreign debt lengthened and external financing in general moved from debt to FDI. Moreover, Chile received a larger supply of external finance (relative to GDP) than other countries in the region, and FDI became a much larger proportion of inflows than in many other developing economies. Colombia's prohibition on foreign equity and bond market participation dramatically reduced the relative importance of short-term, liquid forms of investment finance. More strikingly, FDI became a major source of finance in the country despite political turbulence and blunt financial controls.

The move toward FDI and away from short-term, highly liquid debt and FI flows is a clear achievement of the Chilean model. The Chilean model also afforded policymakers insulation from potential challenges to policy sovereignty via reduction in the risk of crisis. Furthermore, policymakers were able to implement some growth-oriented economic policies because the risk of foreign investor flight was curtailed. The Chilean model also reduced the vulnerability to contagion by fostering macroeconomic stability.

It is noteworthy that the transmission effects of the Asian crisis in Chile and Colombia were quite mild compared to those in other Latin countries (such as Brazil), let alone elsewhere. The decline in capital flows in Chile and Colombia following the Mexican and Asian crises was rather orderly, and did not trigger currency, asset and investment collapse. Contra the experience in Asia, the decision to float the currency in Chile and Colombia did not induce instability.

8.3 Restrictions on currency convertibility

A convertible currency is a currency that holders may freely exchange for any other currency regardless of the purpose of conversion or the identity of the holder. A government can maintain currency convertibility for current account transactions but impose controls on capital account transactions. Moreover, a government can manage convertibility by requiring that investors apply for a foreign exchange licence, which entitles them to exchange currency for a particular reason. This approach allows the government to
influence the pace of currency exchanges and distinguish among transactions based on the degree of currency risk associated with the transaction. The government can also suspend foreign exchange licensing (or convertibility, generally) as a type of speed bump. The government can also control non-resident access to the domestic currency by restricting domestic bank lending to non-residents and/or by preventing non-residents from maintaining bank accounts in the country. Today over 150 countries maintain fully convertible currencies. Developing countries have been pressed to adopt full convertibility (and liberalization of IFPIs) much earlier in their development than did Western Europe and Japan.

8.3.1 Effect on risks

Maintenance of unrestricted currency convertibility in developing economies is highly problematic from the perspective of financial stability. Investors cannot move their money freely between countries unless they can easily convert capital from one currency into another. But the practice of currency conversion and the exit from assets denominated in the domestic currency places currencies under pressure to depreciate. For this reason, unrestricted convertibility introduces currency, flight and currency-induced fragility risks.

Inconvertible currencies can not be placed under pressure to depreciate because there are substantial obstacles to investors' acquisition of them in the first place. Moreover, to the extent that investors are able to acquire the currency (or assets denominated in it), their ability to liquidate these holdings is ultimately restricted. Thus, the likelihood of a currency collapse is trivial because the currency cannot be attacked. The greater are the restrictions on convertibility, the smaller is the scope for currency risk. Convertibility restrictions also reduce currency-induced fragility risk. This measure decreases the possibility that currency depreciation will lead to an unexpected increase in debt-service costs.

Restricting currency convertibility can curtail flight risk. Restricting convertibility can effectively discourage foreign investors from even buying the kinds of domestic assets that are most prone to flight risk because these holdings cannot be readily converted to their own national currency. To the extent that these restrictions do not discourage foreign investors from purchasing assets subject to flight risk, they nevertheless undermine their ability to liquidate these investments and take their proceeds out of the country. Convertibility restrictions also reduce the ability of domestic investors to engage in flight.

By reducing the overall risk of financial crisis, currency convertibility restrictions can reduce sovereignty risk. This measure protects policy autonomy by slowing the rate of depletion of foreign exchange reserves, thereby giving the government time to implement changes in economic policy without being forced to do so by pressures against the currency. Finally, convertibility restrictions can reduce a country's vulnerability to contagion by rendering the economy overall less vulnerable to financial crisis. Insofar as investors know that the economy is less vulnerable to crisis, they are less likely to engage in actions that induce contagion.

It should be emphasized that crises in Asia emerged in an and spread precisely to those countries that failed to restrict convertibility. By contrast, countries that did not maintain convertible currencies — such as China, India and Taiwan — were largely unaffected by the crisis insofar as it was impossible for them to experience a currency collapse (and related currency-induced fragility risk) and the risk of investor flight was minimal. Investors had little reason to fear a collapse of currency and/or asset values in these countries, and they therefore behaved accordingly. It is noteworthy that a recent study of capital account regimes by IMF staff concludes that, despite the efficiency costs and some evasion of Chinese and Indian capital account restrictions, these restrictions are among the factors that can be credited with the performance of these economies during the Asian crisis.

9. Policy considerations and opportunities

I have argued that policymakers have no reason to accept the conventional wisdom that developing countries will benefit from the liberalization of IFPIs. I have also argued that a strong case can be made for capital controls. I conclude with a number of points in this regard.

First, the management of IFPIs is critical to any program of crisis prevention in developing countries.

Second, there is no single form of capital control that is uniformly appropriate. It is the task of policymakers in developing economies to select from a range of controls that represent the most appropriate and feasible means to reduce the specific risks deemed most dangerous to their economy.

Third, policymakers can rely on a package of financial controls rather than any single control (as suggested by experience in Chile, China and India). A program of complementary financial controls can reduce the necessary severity of any one control, and can magnify the effectiveness of the regime of financial control.

Fourth, there is no unambiguous evidence that implementation of capital controls in one or a few developing economies will increase or decrease the hurdle rate necessary to attract IFPIs. The 'hurdle rate' (or the rate of return)
necessary to attract IPCFs may increase if investors demand a premium in order to commit funds to an economy in which liquidity or exit options are compromised. But it is just as plausible to assume that the hurdle rate in such economies may be reduced by a policy regime that gives investors less reason to fear that capital losses will be incurred or growth will be sacrificed because of financial crisis. That foreign investors found Chile and East Asian economies attractive when they had controls in place gives some credence to the latter view (as does investors’ continued fascination with China). It is also the case that capital costs in Malaysia were not punishing, despite the stringent controls during the 1990s.

As a corollary to the fourth point, it is worth acknowledging that the hurdle rate for developing economies as a whole would be lower in a world in which all or most countries impose some type of capital controls. Under a multilateral regime of effective capital controls that reduces ambient volatility and risk, all countries might find it easier and less costly to attract IPCFs.

Fifth and finally, it is far from certain that efforts to reduce the risks of IPCFs will be frustrated by corruption, waste and evasion, and will purchase stability at the cost of stagnation. Contra the claims of the new-political economy, corruption, waste and evasion occur under both liberal and illiberal regimes. Witness, for instance, the accounting scandals that have destabilized US financial markets in recent years. Moreover, a tradeoff between stability and growth has not been established. Indeed, the experiences of Chile, China and Korea seem to contradict this tradeoff. It is at least plausible that foreign investors value stability and predictability (especially in the current environment); hence countries with well-functioning financial controls might have a comparative advantage in attracting IPCFs. Finally, it is important always to weigh the actual costs of instability and crisis against the potential costs of slower, sustainable growth.

In conclusion, I argue that regulation of IPCFs is a central component of what can be thought of as a ‘developmentalist financial architecture,’ by which I mean a financial system that promotes equitable, stable and sustainable economic development. The obstacles that block efforts to regulate IPCFs and to create a developmentalist financial architecture are not technical — they are ideological and political. However, these obstacles are not insurmountable.

We know that on the eve of the Asian crisis the IMF was poised to embrace the liberalization of IPCFs in its Articles of Agreement. In the crisis environment, the IMF quietly tabled the proposal to revise Article 6. The time is therefore ripe for economists to press the case that developing countries should be encouraged to build on the successes of capital controls, and to avail themselves of their Article 6 right to pursue them.
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27 However, it is important to note that FDI is not without its problems. It can and has introduced sovereignty risk and can also aggravate many of the other risks discussed in 6.1-6.4 above if not properly regulated (see Chang and Grabel forthcoming, ch. 16).
28 LeFort and Bodenbach 1997.
30 Arisub et al. 2000, pp. 16-17, pp. 31-4.
31 Grabel 2002b; see also Nissanka and Stein 2003.

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