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We must curb international flows of capital

By Dani Rodrik and Arvind Subramanian

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First large downhill flows of capital – from rich countries to poor countries – led to the Latin American debt crisis of the early 1980s. In the 1990s similar flows begat the Asian financial crisis.

Since 2002 the flows have been uphill, from emerging markets and oil-exporting countries to the developed world, especially the US. But the outcome has not been very different. So, it does not seem to matter how capital flows. That it flows in sufficiently large quantities across borders – the celebrated phenomenon of financial globalisation – seems to spell trouble.

Causes and consequences vary, depending on which way capital flows. Developing country borrowing was associated with unsustainable fiscal policies (Latin America) and inappropriate exchange rate policies (Asia). But the financial sector was not blameless: for every overborrower there was an overlender.

The pathologies were different when the US went on a borrowing binge. Large current account surpluses and the associated savings glut in the rest of the world fed a global liquidity boom, which stoked asset prices. Even though the roots of the subprime crisis lie in domestic finance, international capital flows magnified its scale.

Some would claim that the problem in all these instances was not liquidity but lax regulation, which turned what should have been prudent borrowing into a destructive binge. But this argument is too optimistic about the potential of prudential regulation to stem excessive risk-taking. In the US the entire policy apparatus avoided any regulatory action against lax lending. Even when the will is there, prudential regulation is bound to remain one step behind financial innovation.

If the risk-taking behaviour of financial intermediaries cannot be regulated perfectly, we need to find ways of reducing the volume of transactions. Otherwise we commit the same fallacy as gun control opponents who argue that “guns do not kill people, people do”. As we are

unable to regulate fully the behaviour of gun owners, we have no choice but to restrict the circulation of guns more directly.

What this means is that financial capital should be flowing across borders in smaller quantities, so that finance is “primarily national”, as John Maynard Keynes advised. If downhill and uphill flows are both problematic, capital flows should be more level.

But how is such a levelling-off of flows to be achieved? In the current context, the source of liquidity is large current account surpluses in the oil-exporting countries and east Asia, especially China. Reducing these should be a high policy priority for the international community. Two concrete actions – one for each source of liquidity – suggest themselves.

First, some variant of petrol tax in the main oil-importing countries (including the US, China and India) is essential to cut demand and reduce oil prices and hence the current account surpluses of oil exporters. That such measures should be taken for environmental reasons or that they would reduce the size of sovereign wealth funds only adds to their attractiveness. Second, some appreciation of east Asian currencies is necessary to reduce their surpluses. Even though undervaluation is a potent instrument for promoting growth in low-income countries in general, at this juncture self-interest on both sides calls for an orderly unwinding of current account imbalances.

This appreciation can be achieved either unilaterally or, if necessary, multilaterally through the World Trade Organisation, as a recent Peterson Institute paper has proposed.

Measures needed for when capital flows downhill are likely to take a different form. When appetite for emerging market debt is strong, neither prudential regulation nor macroeconomic policies does much to stem capital inflows. Developing nations need to rely on a broader set of instruments, targeting the capital account directly. Deposit requirements on capital inflows and financial transaction taxes are some of the tools available.

We need an enlarged menu of such options. Unfortunately, capital controls are such a bugaboo that the International Monetary Fund, to its discredit, has done little work on capital-account management techniques.

But will not such interference with capital flows reduce the benefits of financial globalisation? Even leaving financial crises aside, those benefits are hard to find.

Financial globalisation has not generated increased investment or higher growth in emerging markets. Countries that have grown most rapidly have been those that rely least on capital inflows. Nor has financial globalisation led to better smoothing of consumption or reduced volatility. If you want to make an evidence-based case for financial globalisation today, you are forced to resort to indirect and speculative arguments.

It is time for a new model of financial globalisation, one that recognises that more is not necessarily better. As long as the world economy remains politically divided among different sovereign and regulatory authorities, global finance is condemned to suffer deformations far worse than those of domestic finance. Depending on context, the appropriate role of policy will be as often to stem the tide of capital flows as to encourage them. Policymakers who view their challenges exclusively from the latter perspective will get it badly wrong.

The writers are, respectively, professor of international political economy, Harvard, and senior fellow, Peterson Institute for International Economics. You can read a discussion on this article from other leading economists at the Wolf Forum.