In praise of fragmentation

By Adair Turner
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Emerging markets are back in the spotlight. Investors and banks are suddenly unwilling to finance current-account deficits with short-term debt. South Africa, for example, has had to increase interest rates, despite slow economic growth, to attract the funding it needs. Turkey's rate increase has been dramatic. For these and other emerging countries, 2014 may prove to be a turbulent year.

If volatility becomes extreme, some countries may consider imposing constraints on capital outflows, which the International Monetary Fund now agrees might be useful in specific circumstances. But the fundamental question is how to manage the impact of short-term capital *inflows*.

Until recently, economic orthodoxy considered that question invalid. Financial liberalization was lauded because it enabled capital to flow to where it would be used most productively, increasing national and global growth.

But empirical support for the benefits of capital-account liberalization is weak. The most successful development stories in economic history – Japan and South Korea – featured significant domestic financial repression and capital controls, which accompanied several decades of rapid growth.

Likewise, most cross-country studies have found no evidence that capital-account liberalization is good for growth. As the economist Jagdish Bhagwati pointed out 16 years ago in his article "The Capital Myth," there are fundamental differences between trade in widgets and trade in dollars. The case for liberalizing trade in goods and services is strong; the case for complete capital-account liberalization is not.

One reason is that many modern financial flows do not play the useful role in capital allocation that economic theory assumes. Before World War I, capital flowed in one direction: from rich countries with excess savings, such as the United Kingdom, to countries like Australia or Argentina, whose investment needs exceeded domestic savings.

But in today's world, net capital flows are often from relatively poor countries to rich countries. Huge two-way gross capital flows are driven by transient changes in perception, with carry-trade opportunities (borrowing in low-yielding currencies to finance lending in high-yielding ones) replacing long-term capital investment. Moreover, capital inflows frequently finance consumption or unsustainable real-estate booms.

And yet, despite the growing evidence to the contrary, the assumption that all capital flows are beneficial has proved remarkably resilient. That reflects the power not only of vested interests but also of established ideas. Empirical falsification of a prevailing orthodoxy is disturbing. Even economists who find no evidence that capital-account liberalization boosts growth often feel obliged to stress that "further analysis" might at last reveal the benefits that free-market theory suggests must exist.

It is time to stop looking for these non-existent benefits, and to distinguish among different categories of capital flows. Some are valuable, but some are potentially harmful.

Foreign direct investment (FDI), for example, can aid growth, because it is long term, involves investment in the real economy, and is often accompanied by technology or skill transfers. Equity portfolio investment may involve price volatility as ownership positions change, but at least it implies a permanent commitment of capital to a business enter-

prise. Long-term debt finance of real capital investment can play a useful role as well.

By contrast, short-term capital flows, particularly if provided by banks that are themselves relying on short-term funding, can create instability risks, while bringing few benefits.

What is less clear is the best policy response. Capital controls are invariably porous, and we cannot gain the benefits of free trade and FDI without creating some opportunities for short-term investor positioning. China has not liberalized its capital account, but short-term inflows are now driving stronger upward pressure on the renminbi (and larger offsetting reserve accumulation by the People's Bank of China) than can be explained by the current-account surplus and FDI flows. A case can thus be made for capital-account liberalization that is based on the impossibility of effective control, not on any supposed benefits.

But while perfect policy is unattainable, partly effective controls can still play a useful role if targeted at the interface between short-term inflows and domestic credit cycles. After all, capital inflows cause the greatest harm when they drive rapid increases in credit-financed consumption or real-estate speculation.

The required policy response should integrate domestic financial regulation with capital-account management. Tax instruments and reserve requirements that put sand in the wheels of short-term capital inflows should be combined with strong countercyclical measures, such as additional capital requirements, to slow domestic credit creation.

The effectiveness of such measures can be undermined if global banks operate in emerging countries in branch form, providing domestic credit financed by global funding pools. But this danger can be countered by requiring banks to operate as legally incorporated subsidiaries, with locally regulated capital and liquidity reserves, and strong regulatory limits on the maturity of their funding.

Such requirements would not prevent useful capital flows: global banking groups could invest equity in emerging markets and fund their subsidiaries' balance sheets with long-term debt. In banking, as in other sectors, investment that combines long-term commitment with skill transfer can be highly beneficial, which implies that foreign banks should be free to compete on the same basis as domestic banks.

Neither mandatory subsidiarization nor tax- or regulation-based capital controls will solve all of the problems. But, taken together, they can stem the volatility implied by short-term flows and help to smooth out domestic credit cycles.

Much of the financial industry resists such measures, as do the many economists who remain wedded to the old orthodoxy. Renewed capital controls, they claim, would "fragment" the global financial market, undermining its ability to allocate capital efficiently.

In the past, policymakers have been at pains to stress that no such fragmentation will be allowed. But we need to be blunt: Free flows of short-term debt can result in capital misallocation and harmful instability. When it comes to global capital markets, fragmentation can be a good thing.

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