Global capital heads for the frontier

By Dani Rodrik
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So-called “frontier market economies” are the latest fad in investment circles. Though these low-income countries – including Bangladesh and Vietnam in Asia, Honduras and Bolivia in Latin America, and Kenya and Ghana in Africa – have small, undeveloped financial markets, they are growing rapidly and are expected to become the emerging economies of the future. In the last four years, inflows of private capital into frontier economies have been nearly 50% higher (relative to GDP) than flows into emerging market economies. Whether that should be cheered or lamented is a question that has become a kind of Rorschach test for economic analysts and policymakers.

We now know that the promise of free capital mobility has not been redeemed. By and large, the surge in capital inflows has boosted consumption rather than investment in recipient countries, exacerbating economic volatility and making painful financial crises more frequent. Rather than exerting discipline, global financial markets have increased the availability of debt, thereby weakening profligate governments’ budget constraints and over-extended banks’ balance sheets.

The best argument for free capital mobility remains the one made nearly two decades ago by Stanley Fischer, then the International Monetary Fund’s number two official and now Vice Chair of the US Federal Reserve. Though Fischer recognized the perils of free-flowing capital, he argued that the solution was not to maintain capital controls, but to undertake the reforms required to mitigate the dangers.

Fischer made this argument at a time when the IMF was actively seeking to enshrine capital-account liberalization in its charter. But then the world witnessed financial crises in Asia, Brazil, Argentina, Russia, Turkey, and eventually Europe and America. To its credit, the Fund has since softened its line on capital controls. In 2010, it issued a note that recognized capital controls as part of the arsenal of policy tools used to combat financial instability.

Nonetheless, at the IMF and in advanced countries, the prevailing view remains that capital controls are a last resort – to be used only after conventional macroeconomic and financial policies have been exhausted. Free capital mobility continues to be the ultimate goal, even if some countries may have to take their time getting there.

There are two problems with this view. First, as advocates of capital mobility tirelessly point out, countries must fulfill a long list of prerequisites before they can benefit from financial globalization. These include the protection of property rights, effective contract enforcement, eradication of corruption, enhanced transparency and financial information, sound corporate governance, monetary and fiscal stability, debt sustainability, market-determined exchange rates, high-quality financial regulation, and prudential supervision. In other words, a policy aimed at enabling growth in developing countries requires first-world institutions before it can work.

Worse, the list is not only long; it is also open ended. As the advanced countries’ experience with the global financial crisis has demonstrated, even the most sophisticated regulatory and supervisory systems are far from being failsafe. Thus, demanding that developing countries build the kind of institutions that will render capital flows safe not only puts the cart before the horse; it is also a fool’s errand. Caution dictates a more pragmatic approach, one that recognizes a

permanent role for capital controls alongside other regulatory and prudential tools.

The second problem concerns the possibility that capital inflows may be harmful to growth, even if we leave aside concerns about financial fragility. Advocates of capital mobility assume that poor economies have lots of profitable investment opportunities that are not being exploited because of a shortage of investible funds. Let capital come in, they argue, and investment and growth will take off.

But many developing countries are constrained by a lack of investment demand, not a shortage of domestic saving. The social return on investment may be high, but private returns are low, owing to externalities, high taxes, poor institutions, or any of a wide array of other factors.

Capital inflows in economies that suffer from low investment demand fuel consumption, not capital accumulation. They also fuel exchange-rate appreciation, which aggravates the investment shortage. The profitability of tradable industries – those most likely to suffer from appropriability problems – takes a hit, and investment demand falls further. In these economies, capital inflows may well retard growth rather than stimulate it.

Such concerns have led emerging economies to experiment with a variety of capital controls. In principle, frontier market economies can learn much from this experience. As the Johns Hopkins University economist Olivier Jeanne pointed out at a recent IMF conference organized to spur such learning, the capital-flow measures that have become fashionable of late do not work very well.

That is not because they fail to affect the quantity or composition of flows, but because such effects are quite small. As Brazil, Colombia, South Korea, and others have learned, limited controls that target specific markets such as bonds or short-term bank lending do not have a significant impact on key outcomes – the exchange rate, monetary independence, or domestic financial stability. The implication is that capital controls may need to be blunt and comprehensive, rather than surgical and targeted, to be truly effective.

Capital controls by themselves are no panacea, and they often create worse problems, such as corruption or a delay in needed reforms, than they solve. But this is no different from any other area of government action. We live in a second-best world where policy action is almost always partial (and partially effective), and well-intentioned reforms in one area may backfire in the presence of distortions elsewhere in the system.

In such a world, treating capital controls as the last resort, always and everywhere, has little rationale; indeed, it merely fetishizes financial globalization. The world needs case-by-case, hardheaded pragmatism, recognizing that capital controls sometimes deserve a prominent place.

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