Reflections upon Rereading "The Capital Myth"

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Jagdish Bhagwati's celebrated 1998 article on "The Capital Myth" in *Foreign Affairs* reminded us that even those commited to free international trade in goods need not support unfettered international trade in assets, and that some dimensions of economic globalization hold potentially devastating perils. At the time Bhagwati wrote, the recent Asian financial disaster, surely exacerbated by the crisis countries' access to global capital, provided an immediate example of the risks. Bhagwati also reminded us that aspects of globalization promoted politically by the interests that stand to benefit need not enhance welfare more generally, and indeed can generate extreme costs for a large group of losers.

In combining an unflinching advocacy of free trade in goods with skepticism about the value of free international capital flows, Bhagwati stands in a hallowed Columbia University tradition. Ragnar Nurkse, of course, through his chapters in the 1944 League of Nations publication *International Currency Experience: Lessons from the Inter-war Period*, made the case that a combination of floating exchange rates and international movements of short-term speculative capital ("hot money") had helped inflict the financial disruptions of the interwar years. The document formed part of the intellectual case for the original Bretton Woods arrangements, which codified fixed (albeit adjustable) exchange rates and controls on speculative capital flows in order to

[1] Prepared on the occasion of Jagdish Bhagwati's 70th birthday celebration, Columbia University, New York, August 5-6, 2005.

combine some domestic macroeconomic autonomy with an environment conducive to the revival and growth of world trade in goods. Charles Kindleberger (a Columbia Ph.D.) wrote often and at length on the foibles and frenzies of financial markets. And in the early 1980s, Carlos Díaz-Alejandro (1985) incisively analyzed Chile's financial crisis in terms that put at center stage the folly of believing "that financial markets, domestic and international, were no different from the markets for apples or meat" (p. 9). Indeed, the Díaz-Alejandro account reads like a detailed script for the Asian crisis that broke out a dozen years after its publication – and as Cowan and De Gregorio (2005) point out, the 1982 Chilean crisis is rightly thought of as an early example of the "twenty-first century crisis."[2,3]

Halfway through the first decade of the twenty-first century, what have we learned about international capital movements, and where do we stand? I venture an opinion on these questions with some humility. Despite the excellent microeconomic training offered to me in Bhagwati's MIT trade theory course in 1976, I must admit to being a card-carrying macroeconomist, "never a tribe that enjoyed a great reputation for getting things right or agreeing among themselves" (Bhagwati 1998, p. 10). I do believe, however, that we have made considerable progress in our understanding of the inter-related positive and normative aspects of international capital movements. This is not to say that there is anything approaching complete understanding or full agreement. Which

[2] IMF Managing Director Michel Camdessus characterized the 1994 Mexican crisis as "the first financial crisis of the twenty-first century." James Boughton (2001) has suggested that the 1956 Suez crisis may really be the first twenty-first century crisis. On different grounds I would identify the 1890 Baring Crisis as the first twenty-first century crisis. In point of fact, the emerging-market crises that actually have occurred during the current century have – so far! – been fairly localized in their effects.

[3] Díaz-Alejandro's untimely death in the mid-1980s robbed him of the opportunity to witness Chile's spectacular economic and political recovery – a recovery that he certainly would not have foreseen at the time – and robbed us of the benefit of his insightful analysis. The Chilean case yields valuable general lessons, a point to which I return below.

may in part be a good thing: after all, the opportunity for intellectual tribal warfare is surely one of the attractions that draws macroeconomists into the field.

I organize these brief reflections under four headings. First, the problems with international trade in general. Second, the problems with financial markets in general. Third, the gains from trade in assets as between different income classes of countries. Fourth, the role of the exchange rate and the nonfinancial case for capital controls.

International Trade: Widgets versus Dollars

International trade, whether in widgets or in dollars, inevitably carries side effects which can act against the theoretical mutual gains. The difference is one of degree – in general a large difference in degree – though at the individual level the loss of a job due to import penetration can be as devastating as the lsos of a job due to a financial meltdown. Theory teaches us that while in principle trade is Pareto-improving, in practice it carries distributuional effects that create losers as well as winners. To realize the potential Pareto improvement entailed by a move to freer trade, income must be redistributed domestically.

In practice, however, the lump-sum redistributions that would be necessary are *never* made. And it is easy to see why. In a dynamic market economy, change, and with it, shifts in economic fortunes, is constant. Government cannot possibly eliminate all the ex post losses -- and if it did, the resulting adverse economic incentives would seriously impair economic efficiency and growth. Europe and the United States, for example, find themselves on different portions of the equity-efficiency spectrum as result of Europe's greater propensity to provide social insurance in various ways. Regarding trade: outside of a laboratory setting, it is difficult (indeed impossible) to isolate empirically the income redistributions attributable to international trade per se – and therefore impossible to calculate the appropriate compensation. Witness the difficulty economists (not just macroeconomists) have had in determing the role of trade versus technological change on the U.S. wage structure. And if we cannot somehow isolate effects of trade, we are back, in effect, to a regime of continually making transfers to offset all kinds of market-induced redistributions.

So even international trade in goods is a two-edged sword. That is not to deny that the rapid and widespread devastation associated with financial crises overshadows the more gradual effects of changes that originate in the trade accounts. The potential destructive power of financial meltdown is also present, however, in a purely domestic context – that is, even in an economy completely closed to trade and capital movements. Financial collapse can propagate more quickly and destructively, even in autarky, than more run-of-the-mill shocks to goods markets that do not impact the financial system significantly. The interesting question is how these intrinsic problems of financial markets are exacerbated once those markets are opened to the outside world. An answer to this question, in turn, requires an explanation of precisely how dollar markets in general differ from widget markets.

Financial Trade: Domestic versus International

The basic differences relate to the intertemporal nature of financial trades and to the potential for asymmnetric information to eliminate trade gains. Asset trade inherently involves commitment – the commitment to pay on a later date. Payment in reality is therefore always contingent, and the circumstances of contingency can depend on information known to only one party to the deal. Thus, financial transactions inherently must allow for the asymmetric-information distortions that we call moral hazard and adverse selection. These distortions reduce the gains from asset trade that would otherwise be available – even with an efficient and impartial judicial enforcement system. As is well appreciated, government guarantees aimed at mitigating the redistributive effects of financial crises can, in fact, worsen moral hazard and raise the probaility of eventual crises.

Again, the difference compared to goods markets is a matter of degree. A consumer durable yields returns over time, it may be known to the seller to be a "lemon," yet an unconditional service contract may leave the owner with insiufficient incetnives to operate the durable good appropriately. But there is no doubt that commitment and informational problems are by far most severe, and have the widest systemic ramifications, in the financial market setting.

Every country faces the challenge of coping with the potential distortions in financial markets, and they do so through some combination of insurance, prudential policy, transparency requirements, and market discipline. Even leaving aside the international aspects of financial transactions, the ramifications of home-grown crises can be severe in terms of forgone GDP – witness the S&L crisis in the U.S., the Nordic banking problems of the early 1990s following deregulation there, and the drawn-out post-bubble sclerosis of Japan's banks.

These crises have often arisen in the aftermath of deregulation – typically the removal of financial-sector restrictions inherited from the Great Depression and World War II, or, in dveloping countries, a move from the centralized allocation of savings to a more market-oriented system. In many cases, the particular mode of deregulation, driven in general by political imperatives rather than by a sound vision of financial-sector optimality, induced additional moral hazards and abuses. There has clearly been a learning process in coping with these problems, yet new versions of the misuse of other people's money (e.g., Enron) emerge, and most likely always will. Most countries reckon that the advantage of a market-oriented system, even when subject to some political pressures, outweighs the inefficiency and blatant absues that characterized centralized systems of credit allocation. The hope is that the safeguards to the system can gradually be enhanced as result of experience, while avoiding systemic meltdowns. In general, in most of the industrial countries, this approach has done tolerably well so far – though there are clearly current areas of financial excess, such as the home equity market in the U.S.

So domestically, at least, financial markets raise perennial problems. Economists agree that to safeguard its own domestic health, every individual economy should do its best to make its its own financial system immune to systemic crisis within a market framework. Of course, this approach might well entail allowing individual investors to lose and individual institutions to fail. But there is little sentiment (as there was after the disruptions of the earely 1930s) for an all-out assault on domestic finance. The money changers have returned to the temple.

What do *international* financial flows add to the mix? Here we see the second-best analysis of Lancaster and Lipsey in action. If the domestic financial sysetm is distortion-ridden, then eliminating restrictions on asset trade need not improve matters, and may well make them worse. This indeed was the case in Chile in the early 1980s, in Mexico in the mid-1990s, and in Asia later on in the same decade. There is no doubt that, given the existing distortions within the crisis countries' financial sectors, the mode in which financial opening played out – driven by internal politics as well as in some cases by the external U.S. pressures that Bhagwati emphasizes – only enhanced vulnerability.

There are three basic aspects in which the international margin raises potential new problems:

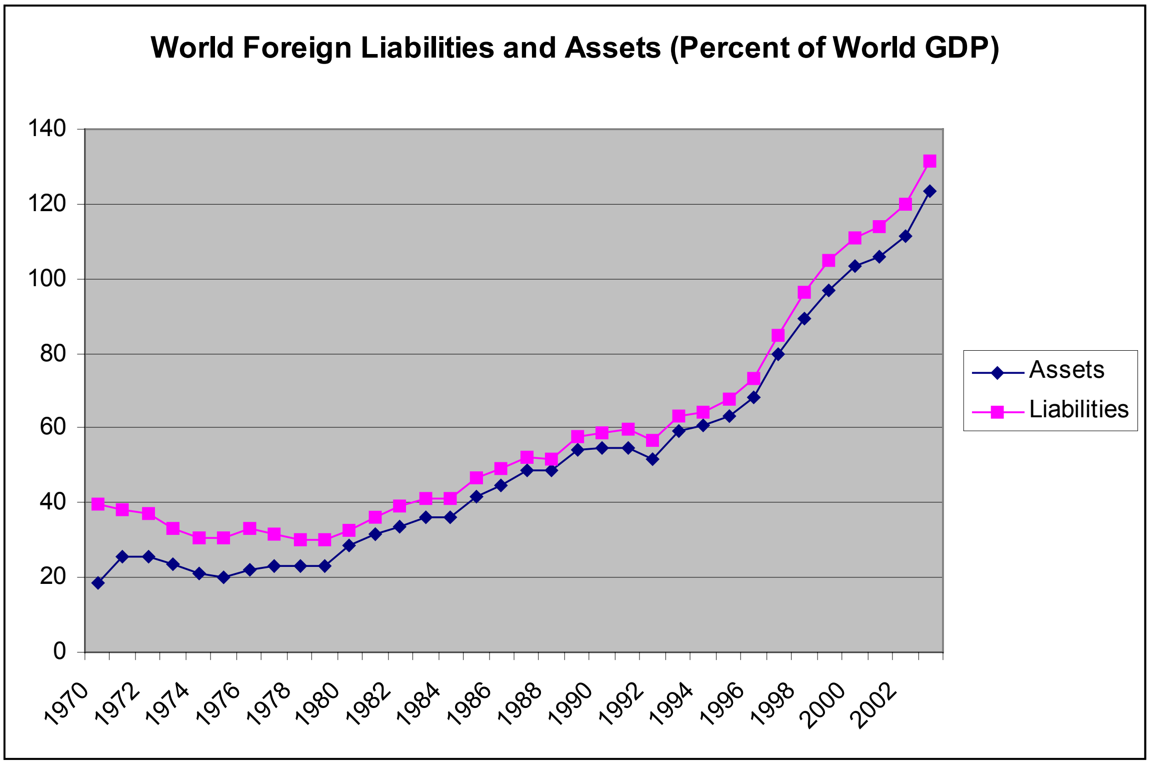
1. Sovereignty. The potential involvement of two (or more) governments as implicit parties to international contracts (Tirole 2002)..
2. Regulatory end-run. International transactions can sometimes be used to evade domestic supervision.
3. Currency mismatch. The potential for unbalanced positions creates a significant additional systemic risk.

The realization of potential gains from international financial trade relies on containing the risks raised by these three factors. If the domestic financial system is not fairly sound on a stand-alone basis, the additional channels for malfeasance provided by financial-account opening can greatly increase the potential for instability. And these channels, if not plugged by international regulatory cooperation and other measures (such as sufficient exchange-rate flexibility), may pose new risks even for a sector that would be quite stable otherwise. Empirically, however, it seems that most crises have resulted from the opening of unsound systems to capital flows – with the resulting levering-up of existing risks – and there are certainly cases (e.g., Japan) where financial problems seem to have little or no connection to international financial flows.

A tentative conclusion is that among richer countries that have addressed the most domestic serious financial-sector problems and have flexible exchange rates, private financial flows have not entailed significant additional financial instability in recent years. Thus, there is at least the potential for creating an environment within which trade in financial assets can yield net welfare gains. Outside of a few exceptional cases, these generalizations do not yet apply, however, to most developing countries, which have suffered quite harshly in financial crises. Mishkin (1996) provides an early analytical discussion of the parrticular financial vulnerabilites of developing countries.

What Gains from Financial Trade?

At a global level there has been an explosion in gross foreign asset positions in recent years. The averages shown in the figure below, which are based on the data of Lane and Milesi-Ferretti (2005), conceal the fact that for some countries – smaller countries and major financial centers – gross foreign assets and liabilities now stand at three or four times GDP. The rapid expansion of gross asset positions, far beyond the minimum asset trade that would be needed to settle current account imbalances, is certainly driven in part by enhanced risk sharing between countries. But it certainly also reflects transactions that, while they do not create additional trade in underlying economic risks, do raise the risk of counterparty failure. Since leveraged international portfolios generally are not balanced in currency terms – for example, the U.S. borrows



overwhelmingly in dollars, but balances its assets more evenly among dollars, euro, yen, and other currencies – exchange rate changes have the potential to redistribute large sums internationally in minutes. So far, however, the international financial system does not seem to have been overly stressed, although, as always, the precise source of the next crisis may not be evident except with hindsight. One cause for current concern is the proliferation in international financial markets of unregulated nonbank actors managing huge portfolios.

There are certainly gains to this financial deepening as between the richer countries. As a micro-level example, the *Economist* of July 30, 2005 ("Augean stables," p. 69) describes how a Japanese bank owned in large part by an American fund manager has formed a joint venure with two German banks to dispose of the latter's non-performing real estate loans. Here we have trade in financial services – the application of American and Japanese know-how on Germany – but also pure asset trade, with gains all around, including enhancement of the German banking sector's productivity.

External financial deepening does not yet extend to most of the developing world, with a few emerging exceptions, of which Chile is one of the most notable. Chile has, however, learned from its troubled past, and both institutional reform and a flexible exchange rate regime have contributed to its apparent ability to engage relatively safely in world capital markets (Cowan and De Gregorio 2005). Other of the poorer countries have not yet reached this stage, and still face difficulties in finding a comfortable reconciliation of open capital markets with the exchange rate regime (see Obstfeld 2004 for further discussion).

Indeed, there can be no doubt that, as Bhagwati argued in 1998, the actual gains to developing countries from opening capital markets have in general been oversold – and sold misleadingly. One strand of emprical literature on trade gains is the study by Gourinchas and Jeanne (2003), who show that the gains to developing countries from borrowing abroad to attain their steady-state capital stocks are very low. The basic problem is that the polities of the poorer countries gennerally offer such low protection of property rights that steady-state capital stocks are themselves low. There is no great incentive to invest, and thus no great incentive for capital inflow from richer lenders. Indeed, in a more recent study, Gourinchas and Jeanne (2005) point out that such capital as does flow to developing countries tends, on net, to flow perversely, to the relatively low productivity locales. Empirical studies have found no robust beneficial causal effect of capital inflows either on developing countries' growth rates or macroeconomic volatility. The problem is that greater beneficial effects of inflows presuppose a level of domestic reform that, if it exists at all, is too recent to be reflected strongly in the historical record to date. Even in a framework like that of Gourinchas and Jeanne (2003), capital inflows will yield substantial benefits if preceded by reforms that raise the desired level of investment and capital (Obstfeld and Taylor 2004). But financial opening, introduced without the requisite reforms, can, as we have seen, be extremely damaging. China, for example, has recently acknowledged this reality by warning that, even though it may be embracing greater exchange-rate flexibility, the end of its external financial controls is at least five years off. But it seems equally clear that even for China, grreater financial integration is a long-term goal.

The hopeful aspect in this picture is that the financial and institutional reforms developing countries need to carry out in order to make their ecoomies safe for international asset trade are *simultaneously* reforms they need to carry out anyway so as to curtail the power of entrenched economic interests and liberate the economy's productive potential. Taken all alone, capital mobility is not a panacea – and it could be poison. Its benefits can be realized only as a complement to a range of domestic policies to enhance stability and growth.

The conclusion that financial integration is inevitable, and eventually even helpful, is in line, I may venture, with another insight asasociated with Bhagwati: the efficient way to correct a distortion is to attack it at to its source.[4] In the present setting, domestic financial market imperfection and institutional weakness, not financial openness, is the primary problem. The ideal response would be a correction of domestic imperfections plus intervention to address the specific additional issues raised by the international margin. Only if this approach is unworkable might a closed financial account be the answer.

The Macro-Monetary Framework

I have alluded at a couple of points above to the importance of the exchange rate system. Indeed, a distinct argument in favor of capital controls is a pure "macro" argument not directly motivated by issues of financial stability: via capital controls, a country can simultaneously attain exchange rate *and* domestic monetary policy targets.

Clearly the revealed preference of the main industrial regions has been to embrace open capital markets, along with whatever gains they bring, and to trade away exchange rate stability in favor of a monetary policy oriented toward domestic objectives. It is not clear that the alternative of capital controls would even be feasible for the industrial countries, given the extent of domestic financial development and the growth of world trade – even in the early 1970s industrial-country capital controls were hard to enforce. Interestingly, the preceding pattern seems to hold also in emerging markets – greater

[4] See especially the classic analysis of policy interventions by Bhagwati and Ramaswami (1963).

exchange rate flexibility, financial sector reform, fiscal and monetary frameworks conducive to moderate and stable inflation – but as Fischer (2003) observes, no generalized retreat from open capital markets (and this in the absence of the type of foreign pressures for financial opening seen in the 1990s). For a number of countries, of course, we also see increasing self-insurance through the acquisition of sizable foreign reserves. I think that reform and restructuring efforts are driven in part by a belief among emerging-market policymakers that integration with the world economy, in finance as well as in trade, is eventually a necessary concomitant of graduation to higher income status.

Developing countries, often characterized by an inability to borrow externally in their own currencies as well as extensive domestic liability dollarization, cannot weather large exchange rate movements as easily as easily as industrial countries can. Furthermore, the need to borrow abroad in foreign currencies imparts a structural disadvantage to their foreign exchange markets, making exchange rates more volatile (Obstfeld 2004). A result is the Calvo-Reinhart (2002) "fear of floating" (Columbia *again*), and with it, reduced monetary autonomy. But fixed exchange rates seem not to be an option – they have certainly contributed in several ways to the harsh character of emerging-market crises. And there is no doubt that a regime with at least some day-to-day exchange-rate uncertainty is a useful preventive measure against crises. Chile's case shows, once again, that progress is possible.

My guess is that international finance, along with the occasional crises it entails, is here to stay. What we learned in the 1990s was that financial opening is a medicine with powerful side effects – it is not for the frail – but when applied after the right preconditions are in place, in can indeed yield benefits. The potential for perverse incentives is always present in financial markets, even more so in the international arena, and the prudential oversight of these dynamic markets requires constant learning and policy adjustment, both by national and international authorities. While there will no doubt be bumps in the road, the more successful emerging market countries seem to be embracing a future in which international financial flows play a key role in their economies, and seem now to understand that wide-ranging domestic reforms, political as well as economic, will be needed before international financial markets can be safely tapped. The conscious implemenation of this approach to economic development was first attempted – evidently with considerable success – by yet another Columbia character: Alexander Hamilton.

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