

# Capital mobility. An overview

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International capital movements have been discussed by economists since the beginning of economics, and the Asian financial crisis has added a vast volume of literature on the subject. I cannot in this short overview pretend to deal with the subject in any depth; I shall focus on developments in the Asian-Pacific region and, in the main, on its literature.

First a little history.

## A little history

Capital has always been internationally mobile, and calamitous flight abroad of speculative capital is no new phenomenon. The 1720 South Sea Bubble and the 1890 Baring Crisis are merely the two most conspicuous pre-1914 examples of a financial crisis precipitated by speculative collapse and capital flight (Kindleberger 1996). 'Hot money' became the sparkplug of the Great Depression of the 1930s.

“The rapid and unpredictable movements of huge volumes of capital from one country to another [...] played a large part in the breakdown of the gold standard during the years 1931-3 and were largely responsible for the unprecedented instability of exchange rates during the nineteen-thirties” (Arndt 1944, p. 285).

In the 19th century international capital movements mainly took the form of transfers of portfolio capital, long-term and short-

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term. “[H]uge flows of capital were effected internationally by the issue of bonds, and to a lesser extent equities, floated principally in London”, by colonial governments and by American, European and other (chiefly railway) companies (Arndt and Drake 1985, p. 375). Little went to underdeveloped countries because, while they lacked capital and therefore had high interest rates, the expected rate of profit on investment, what Keynes called the “marginal efficiency of capital”, was low (Arndt 1954). Short-term capital was raised by overseas banks in the London discount market. After World War I, the international movement of portfolio capital consisted overwhelmingly of US lending to Germany (in effect financing its reparations obligations) and other European countries. The reversal of this outflow in 1929, in response first to the Wall Street stock exchange boom and then its collapse, started the slump (Arndt 1944, p. 15).

International capital flow largely dried up in the Great Depression years of the 1930s but revived after World War II, now increasingly in the new form of direct foreign investment (Arndt 1957). Whereas 19th century long-term borrowing had been largely to finance railway, agricultural and mining development in the USA, Latin America and the British colonies, most direct foreign investment (DFI) took the form of establishment of foreign subsidiaries of manufacturing companies. Much of the capital transfer consisted, not of money but of machinery and other capital equipment. From the 1970s, Britain and other European countries and Japan joined the USA as sources of direct investment, and much of it flowed to Asian countries.

International short-term capital movements played an important stabilising role under the 1870-1914 gold standard regime. The classical theory first expounded by Hume assumed that a balance of payments deficit would be corrected by gold outflow which meant contraction of domestic money supply and (given sufficient cost-price flexibility) improved competitiveness that corrected the balance of payments deficit. In practice, the need for this adjustment, increasingly painful because of increasing wage rigidity, was obviated by short-term capital movements. A balance of payments deficit would raise the discount rate and would thus be financed by an inflow of short-term capital (Bloomfield 1968).

Whereas the gold standard mechanism assumed that the discount rate would be used to restore external balance, the picture

changed in the wake of the 'stagflation' scare of the late 1950s. As monetary policy became the chief instrument for internal balance, short-term capital movements were found to frustrate it; an increase in the interest rate designed to counter inflation by reducing domestic money supply would expand it by attracting short-term capital from abroad. International capital mobility, Robert Mundell argued, was liable to deprive countries of domestic monetary autonomy. Mundell assumed a fixed exchange rate. As the USA and other countries moved to floating exchange rates, domestic monetary autonomy was safeguarded by exchange rate flexibility. The international discipline imposed by the gold standard and by the adjustable peg system of Bretton Woods disappeared.

### **The Asian crisis**

The Asian crisis has spawned a huge literature. There is general agreement that international capital mobility played an important part. But it is not the whole story. Lack of foresight, macroeconomic mismanagement, weaknesses of the financial system and political instability, all in varying degree prevalent in the East Asian countries, contributed to the calamity.

While there were warnings that all was not well (e.g. Hughes 1997), no one foresaw the crisis. Economic growth at annual rates of 6-8% evoked admiration for the 'Asian Tigers' right through the boom years. In retrospect, it has become apparent that growth, especially of exports, slowed down in Thailand in the two years preceding the crash of July 1997, partly because the baht was anchored to the appreciating US dollar (Warr 1998).

In the first few months following the floating of the baht, there was little real sense of crisis. The devaluations were expected to enhance international competitiveness. The Indonesian government appeared to handle the situation judiciously, inviting the IMF in early for consultation (Hill 1999). But during 1998, as the crisis turned into an economic and political catastrophe in Indonesia and spread throughout the region, its dimension became apparent. The impact varied, most serious in Indonesia, Thailand and Korea, less so in Ma-

laysia, the Philippines and Hong Kong, much less in Taiwan, Singapore and China.

The crisis was triggered by the inability of the Thai Government to maintain its fixed exchange rate in the face of accelerating capital outflow. It exemplified the macroeconomic dilemma: "The effectiveness of monetary policy is limited under a fixed exchange rate so long as capital mobility is perfect" (Bhanupong 1999, p. 68). Most East Asian countries maintained fixed exchange rates even in the post-1971 era of floating rates, pegging their currencies against the US dollar or against a basket of currencies (Garnaut 1999). Singapore and Indonesia successfully operated a managed float, Singapore to keep inflation low, Indonesia to maintain competitiveness in the face of domestic inflation. Thailand's abandonment of its fixed exchange rate in July 1997 under pressure of massive capital outflow started the contagion of capital flight and devaluations throughout the region during 1997-98. Hong Kong and China were able to maintain the fixed rate, the former by retaining its currency board system which required adjustment of domestic money supply to the balance of payments, the latter through strict government control of domestic money supply and demand. Most other countries of the region opted for floating, though Malaysia repegged the ringgit to US\$ in September 1998.

A second factor contributing to the severity of the crisis was the fragility of the domestic financial system in many of the East Asian countries. The 1980s and early 1990s had brought financial liberalisation, establishment of numerous private banks (nearly 200 in Indonesia), entry of foreign banks and massive borrowing to finance real estate and other investment, as well as speculation. When the crisis hit, capital flight abroad left banks, particularly in Indonesia, Thailand and Korea, saddled with non-performing loans, on the verge of bankruptcy. Banks and customers had assumed huge exchange risks, confident in the stability of the exchange rate. As the crisis unfolded, it came to be recognised that inadequate transparency and prudential surveillance were part of the trouble. Bailout by the IMF and foreign governments which had worked so well in the Mexican crisis of 1994-95 proved much more difficult because of the larger scale of the crisis and raised important questions of "moral hazard" (Cole and Slade 1999, Grenville 1999b).

Finally, and again most conspicuously in Indonesia, the financial crisis brought to a head, and was intensified by, political disorder. "In

Thailand and Indonesia the political structure prolonged the crisis and thus intensified economic destruction” (MacIntyre 1999, p. 156). In Thailand the problem was indecisiveness of political leadership; in Indonesia the crisis brought down the Suharto regime. In both countries, political turmoil further undermined investor confidence.

While all three factors played a part, the crisis was caused by unprecedentedly large and volatile international capital flows. It is this capital mobility which is the focus of this overview.

## Globalisation

The greatly increased international mobility of capital is part of what is fashionably called “globalisation”. “What has changed is the ease and speed with which goods and services, and capital, can move from one country to another” (Arndt 1998, p. 73).

TABLE 1

CAPITAL FLOWS TO EMERGING MARKETS  
(annual averages, \$ billion)

	1977-82 <sup>a</sup>	1983-89	1990-94	1995	1996	1997
<b>All emerging markets</b>						
Total net capital inflows	30.5	8.8	120.8	192.0	240.8	173.7
Net foreign direct investment	11.2	13.3	46.2	96.0	114.9	138.2
Net portfolio investment	-10.5	6.5	61.1	23.5	49.7	42.9
Other <sup>b</sup>	29.8	-11.0	13.5	72.5	76.2	-7.3
<b>By region</b>						
Asia	15.8	16.7	40.1	95.8	110.4	13.9
Western Hemisphere	26.3	-16.6	40.8	35.7	80.5	91.1
Other	-11.6	8.7	39.9	60.5	50.0	68.8

<sup>a</sup> 1977-89 figures exclude economies in transition and some Middle Eastern emerging markets.

<sup>b</sup> Includes bank lending.

Sources: IMF (1995, p. 33 and 1998, p. 13).

Table 1 (Grenville 1999a) summarises the volume, structure and growth of international capital flows to emerging markets during the two decades 1977-97. Between 1977 and 1996, capital inflow to Asia increased sevenfold, but declined by more than a quarter in 1998, entirely because of the collapse of bank lending. (Net foreign direct investment continued to rise, and even portfolio investment was more or less sustained, except in Malaysia where it fell sharply in 1997.)

Much of the growth of long-term, direct and portfolio, investment was related to East Asian industrial development, manufacturing, urban construction and transport and other infrastructure. Portfolio investment and bank lending grew with trade liberalisation and expansion. In the late 1980s and early 1990s investment in urban real estate, especially in Thailand, Korea and Indonesia, became increasingly speculative. But the real estate 'bubble', while it became a major feature of the economic collapse, was not in itself the cause of the crisis.

The chief culprit was the extraordinarily rapid growth and volatility of short-term international capital movements, mostly bank lending, but during the 1990s also the operations of large and active hedge funds.

Easy access to international finance which this growth implied was one of the benefits of globalisation – opening up of national economies through deregulation and advance in communication technology. But technological advance, the astounding speed of electronic transfer of funds in the 'new economy', also increased the volatility of short-term capital.

### Hot money

Capital flight, 'hot money', as we have seen, has been a symptom of "Manias, panics and crashes" (Kindleberger 1996) for centuries. But in 1997-98 it assumed catastrophic dimensions. Capital inflow of US\$ 93 billion into the five worst affected East Asian countries (Indonesia, Korea, Malaysia, Thailand, Philippines) in 1996 gave way to a net outflow of US\$ 12 billion in 1997. In Thailand, the central bank sought to defend the baht's parity against speculative attacks but finally let the peg go on 2 July 1997 when it had lost US\$ 23 billion of its foreign exchange reserves.

Once currencies began to slide, loss of confidence turned into panic. As in the bank rushes of earlier domestic crises in the USA and elsewhere, the herd instinct signalled *sauve qui peut*. Between October 1997 and March 1998 US\$ 75 billion fled from the five countries (Grenville 1999a, p. 6). In Indonesia a large proportion of Chinese business capital was transferred abroad, leaving scores of private and some state banks on the verge of bankruptcy.

Capital flight was unimpeded because most of the crisis countries maintained an open capital account. Capital controls had long been a contentious issue. Keynes at Bretton Woods had argued for abolition of all trade and foreign exchange controls *except* control of short-term capital movements which had caused so much damage in the 1930s.

Indonesia opened its capital account in 1971, partly because leads and lags and smuggling from the island archipelago made controls virtually unenforceable but also on the principle that, to attract foreign capital, one has to guarantee its freedom to leave. For 27 years, the open capital account had caused no trouble.

In Malaysia, Prime Minister Dr. Mahathir, after initially reacting to the crisis by denouncing currency speculation – “A Jewish conspiracy to jeopardise the Malaysian miracle” (Athukorala 1999, p. 33) – in August/September 1998 imposed stringent controls on short-term capital movements. Among other measures, ringgit deposits abroad ceased to be legal tender and the use of the ringgit as an invoicing currency was banned. The other crisis countries maintained open capital accounts, anxious to induce foreign capital to return.

## Policies

What, in the light of this brief survey, should be done about the problems of capital mobility highlighted by the Asian crisis?

One should begin by agreeing with Grenville (1999a, p. 2) that

“international capital flows are a Good Thing. Financial flows supplement domestic saving, allowing more investment to be made in countries where returns are highest; they buffer variations over time between exports and imports; FDI brings the advantages of technology transfer; [and] there are gains for savers from diversification”.

From the large literature on the Asian crisis four policy issues stand out: 1) the pros and cons of capital controls, 2) the choice of exchange rate regime, 3) financial sector reform, and 4) the rule of law.

1) Capital controls. There is even now no consensus on this much debated matter. Bhagwati in an influential article in 1998 advo-

cated controls on short-term capital outflow. But the dominant view is probably that it is best to maintain an open capital account and pursue monetary and exchange rate policies which minimise the risk of capital flight. Tobin (1998) has proposed a tax on capital outflow, "sand on the wheels", to reduce capital mobility. Like other controls, it may be difficult to enforce. Chile for some years imposed a reserve requirement on capital inflow but reduced it to zero (retaining it for future use) in July 1998 when inflow had dried up. Even Malaysia eased its controls. In August 1999, the complex tax on remittance of portfolio investment profits was replaced by a simple 10% levy. Both countries experienced a good recovery to which, in the view of some commentators, the controls made a useful contribution.

2) Exchange rate regime. Here, too, opinion remains divided. The USA and most other developed countries (with the notable exception of the European Union) continue to allow their currencies to float. Many emerging countries anchor their currencies to the US dollar (or a basket of floating currencies) and thus float with them while retaining exchange rate stability in their trade with the anchors. In East Asia, China and Hong Kong stick to a fixed exchange rate against the US dollar. A floating rate relieves the country of international discipline over its domestic macroeconomic policy, but it imposes exchange risk on traders and investors. Failure to hedge against this risk bankrupted thousands in 1997-98, but whether hedging is worthwhile depends on the interest and transaction cost.

3) Financial sector reform. The Asian crisis uncovered serious deficiencies in the management and supervision of banks and other capital market institutions in East Asian countries. In Indonesia, scores of banks failed, overwhelmed by non-performing loans. "In January 2000, Bank Indonesia estimated that the total amount of government bonds needed to recapitalise the banks would be Rp 621 trillion, which is 51% of GDP in 1999/2000 fiscal year" (Fane 2000, p. 28). Korea and Thailand had the same problem on a smaller scale. Bank restructuring is underway in all three countries, but as yet far from complete. For the future, what is needed is provision for more effective prudential surveillance and insistence on transparency.

A much discussed issue is the role of the central bank as lender of last resort and bailout by the IMF and other sources of emergency aid. During the Mexican crisis of 1994-95 bailout was ar-



ranged successfully, but has raised the controversial issue of conditionality and the touchy question of 'moral hazard'. One suggestion is that the private sector needs to be "bailed in", made to bear some of the cost (Grenville 1999b).

4) The rule of law. Capital mobility has posed serious problems, but the Asian crisis would have been more manageable had the political infrastructure not aggravated it in some countries, especially, Indonesia, Thailand and Korea (MacIntyre 1999). Corruption has been endemic in all of East Asia (except Singapore) and capital mobility has greatly increased the gains available to corrupt operators (Hughes 1999). A weak judiciary and political instability have, especially in Indonesia, compounded the problem. Establishment of the rule of law is one part of the task of minimising the adverse effects of capital mobility.

Finally, a few words about two issues which the Asian crisis has shown to be relevant to capital mobility.

One is the role of the IMF. This has been hotly debated by economists and commentators (not to mention green and red demonstrators, but these are just as hostile to the World Bank and WTO). Some have argued that the IMF mishandled the crisis, its prescriptions too tough, turning a financial into an economic and social crisis (Stiglitz 1998 and 2000). Others have defended the IMF, pointing to the substantial 'V-shaped' recovery in Korea and other Asian crisis countries. "The IMF's policies worked" (Dornbusch 1999). As so often, the truth lies in between (cf. Corden 1999). The IMF did make mistakes, especially its unnecessarily harsh prescriptions for Indonesia in late 1997. But it remains indispensable as regulator, adviser and international lender of last resort.

The second issue is one first raised by Corden (1977) and later made much of by Pitchford in Australia (1989), that a current account deficit does not matter and should not be a target of policy. It was Thailand's rapidly growing current account deficit in 1997 that undermined confidence in the baht and precipitated the crisis. A floating baht might have avoided the panic and slowed capital outflow but, as I have argued (Arndt 1989), it would have had other adverse effects. A large current account deficit cannot be ignored.

## Conclusion

The object of this paper has been to review the large literature on capital mobility spawned by the Asian crisis of 1997-98 and the policy issues under discussion. No clear consensus has emerged on the issues of capital controls and exchange rate policy. On the former, temporary controls, perhaps on the Chilean model of a tax on inflows, have some support. On the latter, while the main currencies float, many emerging countries anchor their currencies to one of them and therefore float with them but in effect maintain a fixed rate to the anchor. Financial sector reform remains an urgent task in all the Asian crisis countries. The 'moral hazard' problem highlighted by the bail-out of the Mexican crisis has suggested 'bail-in' as a safeguard.

Capital mobility is a desirable, indeed essential, feature of an increasingly open world economy. The task is to reap its benefits and minimise its costs.

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