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## Should We Still Support Untrammelled International Capital Mobility? Or are Capital Controls Less Evil than We Once Believed?

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# Should We Still Support Untrammelled International Capital Mobility? Or are Capital Controls Less Evil than We Once Believed?\*

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## Summary

Fifteen years ago, I found it easy to be in favor of international capital mobility — the free flow of investment financing from one country to another. Then it was easy to preach for an end to all systems of controls on capital that hindered this flow. Now it is harder.

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Fifteen years ago, I found it easy to be in favor of international capital mobility — the free flow of investment financing from one country to another. Then, it was easy to preach for an end to the systems of controls on capital that hindered this flow.

"Why not free up capital flows, to encourage large-scale lending from the world's rich countries to the world's poor countries?" I, and others, asked. Such lending, we hoped, might cut a generation off the time it would otherwise have taken developing countries' economies to catch up to the industrial structures and living standards of wealthier countries.

More than a century ago, large-scale borrowing and lending had played a key role in the economic development of the late-nineteenth century temperate periphery of Canada, the western United States, Australia, New Zealand, Chile, Argentina, Uruguay, and South Africa. Why shouldn't it similarly benefit twentieth century developing countries?

This reasoning seemed compelling then. Today, however, it is much harder for me to support untrammelled international capital mobility. I am no longer as sure that capital flows are efficient. Too many external costs associated with financial crises, and the fact that capital seems to want to flow not from, but to, where it is already abundant, make me fear that my standard economist's model is simply not working.

Worse yet, even if capital flows *are* efficient, it seems increasingly likely that these flows could benefit rich people from poor countries at the expense of the countries themselves — including their poor.

Thus, lifting capital controls — far from helping the world's poor, as many had hoped — may actually hurt them.

### **The Dream of International Capital Mobility**

To see why capital mobility has not lived up to our earlier dreams, it is important first to describe exactly what those dreams were in the first place. Neoliberals like myself saw three important reasons that removing capital controls could potentially improve life in poor countries. But history showed that, in practice, these improvements did not happen as we had hoped.

First, the resulting capital inflows, we thought, would directly boost production and productivity. Capital controls had kept the level of investment in

peripheral developing countries down, or so we believed. This seemed to be a very bad thing. Higher investment boosts a country's capital stock, and thus directly raises labor productivity and wages.

Second, we thought that with capital controls removed, developing countries' industries and people would enjoy the benefits that flow from technological advances, and from learning-by doing using modern machinery. After all, such benefits had been at the heart of so much of the productivity growth of the past two centuries.

Third, capital controls created large-scale opportunities for corruption and we hoped that the removal of capital controls would reduce corruption and improve the quality of government in these countries. In highly corrupt societies, tax rates and the regulatory barriers to starting businesses, are idiosyncratically and randomly high. Such societies cannot be productive nor equitable.

Whoever got the scarce permissions to borrow abroad had a good chance of becoming rich, and somehow those who got them often turned out to be married to the niece of the vice-minister of finance. When capital controls are in place, people who badly want to move their capital across borders cannot — unless they can find some complaisant bureaucrat. A well-functioning market economy needs to minimize the incentives and opportunities for corruption or it will turn into something worse.

Together, these three reasons seemed to make up an overwhelming case for lifting capital controls. The world's system of relative prices is tilted against the poor: the products they export are cheap, yet the capital goods they must import in order to industrialize and develop are expensive. The hope was that this inequity could be at least partially remedied by open capital flow.

### **Proof that the Dream Didn't Come True: Mexico's Example**

Working at the U.S. Treasury in 1993, I naively projected that after NAFTA, there would be a net capital flow of some \$10 to \$20 billion a year to Mexico for decades to come. I predicted that investors around the world would now build factories in Mexico, where they not only could pay low wages to workers, but could enjoy guaranteed tariff-free access to the largest consumer market in the world. Sadly, however, it did not turn out that way.

Here is what's really happening. The good part is that Mexican workers and entrepreneurs are gaining experience in export manufactures, and exporting

enough to the U.S. to run a trade surplus. But the flip side of the trade surplus is a capital outflow — from Mexico to the U.S., rather than from the U.S. to Mexico. Should capital-poor Mexico really be financing a further jump in the capital intensity of the U.S. economy?

Why didn't this dream come to fruition? There are several basic explanations for the disparity between dream and reality.

### **One Problem with the Dream: Cash Flow Into, Not Out of, Rich Countries**

One basic problem for the dream was that capital did not, in practice, flow from rich to poor, as we'd hoped. Instead, it flowed from poor to rich — and overwhelmingly, in recent years, into the United States.

The U.S.'s rate of capital inflow is now the largest of any country, anytime, anywhere. The U.S. economy became, and remains, a giant vacuum cleaner, soaking up all the world's spare investible cash.

How much money, exactly, are we talking about? As best we can calculate, the United States has run current-account deficits averaging 2.5% of GDP over the past two decades—that's \$270 billion a year at today's level of GDP.

It is true that at most only one-third of this — about \$90 billion — can be attributed to inflows from the developing world. But from the perspective of the developing world, that is an overwhelming, crushing amount of money. Consider, for example, that \$90 billion a year is the (current exchange rate) income of the poorest *500 million* people in India.

At this point, we must concede that the hope for a repetition of the late nineteenth-century experience — in which core investors' money gave peripheral economies the priceless gift of quick economic development — has so far proved vain.

### **Why Capital Flowed Into, Not Out of, Rich Countries**

The facts are clear: Capital is flowing into the U.S. and other wealthy countries, and not into poorer countries. But what are the reasons?

Some may say the inflow of capital into America was and is justified, because of the high quality of American investments. But if these investment

opportunities are truly so great, why aren't Americans themselves saving more — both privately and publicly — to take advantage of them?

In fact, it seems that the reasons capital flowed into American and other countries were largely *not* based on the supposed superiority of their investments. International capital mobility was supposed to add to, not drain, the pool of funds financing development in peripheral countries. Why didn't it happen that way? Which investors and banks, in particular, chose to send capital to the U.S. and other wealthy countries, rather than to developing countries?

First, there were first-world investors who feared investing in developing countries. They worried about sending their money down the income and productivity gap after the crises of Mexico '95, East Asia '97, and Russia '98. U.S. investments, while potentially less lucrative, seemed much more stable. In particular, techno-enthusiasts were prone to chase the returns of the American technology boom.

Second, there were investors, governments, and banks from developing countries themselves. Central banks sought to keep the values of their home currencies down so that their workers could gain valuable experience in exporting manufactured goods to the post-industrial core.

Third, the third-world rich often thought a large Deutsche Bank account would be a good thing to have in case something went wrong and they suddenly had to flee the country in the rubber boat (or the Lear jet). Again, stability in investment — as opposed to potential future returns — was the key.

Many billions of dollars of capital has fled Russia in the past decade. These capital exports were presumably in the interest of the Russian oligarchs who moved their wealth to Finland and Cyprus. The example of Yukos baron Khodorkhovsky — who now sits in jail for displeasing President Putin — suggests that they were personally very wise to do so. But did their actions benefit Russia as a whole?

### **Another Problem with the Dream: Increased Systemic Risk**

Even more worrisome than the fact that money seemed to be flowing in the wrong direction, was the increased vulnerability of peripheral countries with open capital flows to financial crises.

Currency mismatch, duration mismatch, and risk mismatch left Mexico, East Asia, Brazil, Turkey, and others desperately vulnerable when first-world investors' perceptions turned against them.

Advocates of mobility such as myself suggested that these risks could be dramatically lessened. We suggested that before controls were lifted, it was important to first establish an effective system of financial regulation. Such a system, we hoped, could ensure that financial firms' bets would not create large amounts of systemic risk.

This hope, however, was too optimistic. Consider that the U.S. does not have an easy time regulating its financial system when the salary differential between the bureaucratic regulators and those they regulated is five to one. Then ask yourself: What chance does an Indonesia, a Thailand, or a Brazil have when the salary differential between the bureaucratic regulators and those they regulate is *ten to one*?

With a disparity like this, the regulators are nearly powerless — unable to enforce the regulations they opt for — and those who are regulated are immensely powerful in comparison. It's no surprise that regulation is ineffective.

### **Comparing Theories of International Lending: Two Eras, Two Approaches**

1960-85 was the era in which development was to be financed by *public* lending by institutions like the World Bank. The idea was that market failures and distrust of governments had made it very hard for poor countries to borrow on the private market. But public lending would fill the breach. This era was hardly an unqualified success. But neither was the era that followed — the era we are living in now.

1985-2004 has been the era in which development was to be financed by *private* lending, from first world investors to those countries that had adopted the free market policies that were supposed to produce high returns and rapid growth. But again, it didn't happen that way: First-world investors didn't invest in developing countries, and indeed, to the contrary, developing countries often invested in the first world — especially the United States.

It's hard, then, to say that the second era has been better than the first. The anti-corruption effect of opening up capital flows still remains. But the other hoped-for effects — capital flow to poorer countries, and corresponding technological advances — did not occur as planned.

### **Can the Reverse Capital Flow, From Poor To Rich Countries, Be Defended?**

Can the flow of capital from poor to rich countries be defended? Perhaps from an efficiency standpoint — but not from any standpoint that considers even modest hopes for income equality.

It seems plausible that this reverse capital flow is economically efficient. Rich Mexicans certainly have the choice between investing in their own country and investing in America, and they are deciding to do the second. They may be seeking high expected returns in the U.S. — the U.S. is, indeed, an immensely productive, technologically inventive, and potentially fast-growing economy. They may also be diversifying against economic and political risks: you want to have something in America in case the rubber boat scenario comes to pass. (What better way to get your grandchildren the option of moving to the United States than by having large investments there?)

A standard economic analysis might stop here: It might say that while it is surprising that the net flow of capital is from poor to rich and not from rich to poor, the market knows best. The market is efficient, and voluntary acts of economic exchange are mutually beneficial. Never mind that they do not achieve the increased parity of rich and poor that we dreamed of — and indeed, that they may have just the opposite effect.

### **A Flawed Situation That May Still Be The Best We Can Do**

For anyone who cares at all about income equality, the current situation is disturbing. Already dramatic inequalities may only be exacerbated by reverse capital flow from poor to rich countries.

Nevertheless, a card-carrying neoliberal like myself still cannot wish for any but the most minor of controls to curb the most speculative of capital flows. Capital markets can get the allocation of investment badly wrong. But governments are likely to get it even worse. In addition, the incentives for bureaucrats to become corrupt must be kept as low as possible. In the end, we may have to tolerate the equality-lessening reverse flow of capital, in order to promote the equality-increasing and wealth-increasing diminution of corruption in less developed countries.

For further reading:

Michael Mussa's 2002 IIE book, *Argentina and the Fund: From Triumph to Tragedy* (<http://www.developmentgateway.org/node/146201/dg-contribute/item-detail?item%5fid=238741>).

Morris Goldstein's 1998 IIE book, *The East Asian Financial Crisis* (<http://www.powells.com/cgi-bin/biblio?inkey=91-0881323241-0>)

Nouriel Roubini's Global Macroeconomics website  
(<http://www.stern.nyu.edu/globalmacro/>)