Chapter 2: Literature review

2.1 Capital controls in the postwar period

Capital controls, which have been the most important impediments to market access, have seldom completely eliminated all flows, but they have made international transactions more costly and have eliminated certain types of flows.

During the Great Depression, economic warfare was characterized by restrictions on trade and payments. It was therefore decided that restrictions on goods and services should be abolished, thereby liberalizing the transactions on the current account of the balance of payments (Hoffmeyer, 1978) through the General Agreement on Trade and Tariffs (GATT) (Hauge, 1978).

On the contrary, the references to capital movements were scant. In the two main plans leading to the Bretton Woods system, namely the Keynes Plan and the White Plan, some discussion actually took place on the role of capital movements. The general idea was that some sort of restrictions on capital movements was necessary. On this point Keynes especially was very clear: 'It is widely held that the control of capital movements, both inward and outward, should be a permanent feature of the postwar system' (Hoffmeyer, 1978 p23). Nevertheless, it was finally left to the individual countries to determine capital movements.

In the final version of the International Monetary Fund (IMF)'s Articles of Agreement, capital movements were only mentioned briefly in Article VI which states: "A member may not use the Fund's resources to meet a large or sustained outflow of capital... and the Fund may request a member to exercise controls to prevent such use of the resources of the Fund." Finally, regarding controls on capital transfers, it was decided that: 'Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for

current transactions or which will unduly delay transfers of funds in the settlement of commitments...' (Hoffmeyer, 1978).

Thus, it was clear that the agreement gave the IMF a mandate to encourage free trade but did not give it jurisdiction over capital controls. Capital controls were an accepted part of the international monetary system following World War II (Hoffmeyer, 1978, Hauge, 1978; Goodman and Pauly, 1993). Most industrial countries accepted the convertibility of currency but strongly guarded their right to control short-term capital flows.

Nevertheless, there was a slightly different development in the Organization for Economic Co-operation and Development[1] (OECD). In Article 1(a) of the Code of Liberalization of Capital Movements (1961), OECD member countries[2] pledged to undertake to 'progressively abolish between one another ...restrictions on movements of capital to the extent necessary for effective economic co-operation'. However, the liberalization obligation with respect to international capital flows is a limited one. During the early years under the Code, say 1960-68, the use of capital controls was widespread among the OECD countries (OECD, 1982). For example, even the United States (US) used controls to prevent 'disequilibrating' capital outflows in 1963 (Hauge, 1978; OECD, 1982; Kindleberger, 1987) and only removed the controls in 1965 when the market had been stabilized. Facing persistent payments imbalances and problematic exchange rate rigidities in the 1960s, virtually all leading industrial countries resorted to some type of controls on capital movements.

With the introduction of the flexible exchange rate regime from the beginning of 1973 onwards, the official attitude towards the use of capital controls has been relaxed. In principle, the transition to a regime of flexible exchange rate allows

[1] The members of OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.
[2] Except for Canada.

policy-makers more autonomy in monetary policy[3] making and greater freedom of capital movements (OECD, 1982; Jomo, 1998).

The rapid growth of international financial markets and the increasing globalization of production, as evident in the rapid growth of foreign direct investment (FDI) between the late 1970s and the early 1990s, also dramatically reduced the usefulness and increased the difficulties in the application of capital controls (OECD, 1982; Lessard and Williamson, 1987; Dornbusch, 1991). They pointed out that multinational structures and the deepening of financial markets enabled firms to adopt strategies of exit and evasion. They can evade capital controls by charging transfer prices or altering the timing of payments to or from foreign subsidiaries. If controls in a country became too onerous, multinational enterprises could also attempt to escape them altogether by transferring activities abroad, that is, by exercising the exit option.

Other factors contributing to the elimination of capital controls is an institutional one. The major industrial countries like the US and international organizations like World Bank and IMF are strongly promoting global financial liberalization. Thus, institutional factors have also made the capital controls obsolete in today's financial and economic environments.

2.2 The post Bretton Woods international capital market

2.2.1 The market and the capital flows

The division between the monetary system and the capital market is not as clear-cut as it sounds, because the system and the market are entwined, integral parts of the world economy. Hauge (1978) refers to the international money market as the market in Eurocurrency, and the international capital market as the mechanism for medium-term and long-term finance provided by internationally syndicated bank loans and by two classes of international bonds: (1) the

[3] Under fixed exchange rate regime, the policy-makers seemed to face a choice between exchange controls or to face a loss of reserves or a loss of monetary autonomy.

traditional foreign bonds for nonresident borrowers in a domestic capital market, and (2) Eurobonds placed throughout the world by international syndicates of investment banks and securities firms.

However, the definition is not conclusive as global flow of funds also embraces such elements as short-term financing of international trade, FDI, and official loans and grants.

The growing part played by the international market in transmitting capital across the world represents an important change in the 1970s. For a considerable time after 1945, a far larger proportion of international capital consisted of official flows, initially for the reconstruction of Europe and Japan and, thereafter, for development of the world's poorer countries (Hoffmeyer, 1978; Hauge,1978; Hussain and Kwang, 1992). At the time, most leading financial centers were still either closed to foreign borrowers or were severely restricted in their access.

An explosion of international financial flows[4] occurred following the breakdown of the Bretton Woods system of fixed exchange rates which was replaced with a new system of flexible exchange rates. Under the new regime, the volume of foreign exchange spot transactions had grown to more than 67 times the total value of the international trade in goods by 1995, or more than 40 times the value of international trade (including services)[5] (Jomo, 1998).

The channeling of a greater proportion of capital through the international capital market has important implications. This kind of funding tends to go to the advanced developing countries, unlike official aid which is made available more broadly throughout the developing world and which is often provided not only for economic reasons. Moreover, through the more efficient allocation of resources, the market tends to speed the process by which the older economies are faced

[4] The distinction between financial flows/movements and capital flows/movements is not apparent and the terms are used interchangeably throughout the paper.

[5] One key question is how much of those investment-related trades are 'healthy', appropriate', or 'desirable'. International investors want to hedge their personal income and wealth by spreading their

with new competition from the advanced developing economies (Hauge, 1978; Revira-Batiz, 1989).

Consequently, the market allows deficit countries a certain period in which to make a less abrupt and less painful adjustment than might otherwise be forced on them. But time, of course, is not unlimited.

2.2.2 Trends of capital flows

As pointed out by Goldstein *et al.* (1991), there are 4 major trends of capital flows during the 1970s and 1980s, namely:

(i) sharp expansion in scale of net and gross capital flows in major industrial countries;

(ii) globalization and integration of offshore and major domestic financial markets due to the progressive relaxation of capital controls as well as the broader financial liberalization in industrial countries;

(iii) dominant role of private flows in financing fiscal and current account imbalances for the developing countries in the 1970s and for the industrial countries in both the 1970s and the 1980s; and

(iv) similarities between the early 1970s and the late 1980s in patterns of official and private capital flows to developing countries, that is official flows were important for financing the current account deficits of both the net-debtor and non-debtor developing countries.

In the 1990s, private capital flows especially portfolio funds have dominated the international capital markets and created destabilizing effects on economic equilibrium. Although international capital flows can potentially play an important role in improving economic efficiency, the closer integration of major capital markets could subject the world economy to various systemic strains where

investments across countries and adjusting them quite frequently as conditions change, thus contributing to market volatility.

major financial shocks could be transmitted across global markets (Goldstein *et al*, 1991; BNM, 1997), as evidenced from the recent Asian financial crisis.

2.3 Significance of capital mobility

2.3.1 The benefits

The progressive relaxation of capital controls as a result of the broader financial liberalization in the industrial countries has brought about a growing integration and globalization of major offshore and domestic financial markets. It allows many investors (often institutional investors such as insurance companies and pension funds) to diversify their portfolios internationally (Goldstein *et al*, 1991; Jomo, 1998). This diversification has been facilitated by the advancement in computer and telecommunication technologies as well as the proliferation of new financial instruments (BNM, 1997).

In the highly integrated international capital markets, domestic saving and investment need not be tightly linked, since domestic investors can rely on external financing. Access to international financial markets offers some clear-cut benefits by providing additional sources of financing and investments to the domestic economy (Rivera-Batiz, 1989). The surge in capital inflows could be the engine of growth in domestic demand, output and capital stock (Bercuson and Koenig, 1993). Various studies[6] as pointed out by Lim (1996) had shown that capital accumulation was the most important contributor to output growth in the slower-growing and poorer economies. It also offers borrowers the deeper reserves of savings and gives the investors more investment opportunities (Anjaria, 1998).

Correspondingly, capital-poor countries (i.e. most of the developing countries) should be the major beneficiaries of an integrated international capital market that efficiently transfers resources from capital-rich to relatively capital-poor regions for greater economic performance and efficiency gains. Yet there was only a

mixed evidence of a smooth transfer of resources (Goldstein *et al.*, 1991; Eatwell, 1997). Eatwell suggests a negative correlation between dependence on 'foreign savings' and economic performance. Whereas Hauge (1978) and Rivera-Batiz (1989) highlighted that the low-income developing countries' access to international financial market has been limited.

The evidence is clear if we were to examine the pattern of private flows in the capital accounts of the US, Germany, and Japan in the 1980s. For example, between 1983 and 1988, when the US ran a cumulative current account deficit of $644 billion, inflows of portfolio investment, other private short-term capital, and net FDI financed about 75% of the external deficit. This sharp upswing in the level of net capital flows among the major industrial countries has been the counterpart to the historically large current account imbalances during the 1970s and 1980s (Table 1). And private flows has becoming increasingly important in financing the current account deficit (Melvin, 1992).

Table 1: Net International Capital Flows of Major Industrial Countries, 1970-88 (Period averages)

	Germany			Japan			United States		
	1970-72	1979-81	1985-88	1970-72	1979-81	1985-88	1970-72	1979-81	1985-88
Capital account balance[1] (US$' billion)	-0.98	7.57	-37.6	-4.79	4.77	-75.1	1.63	-2.36	128.7
Capital account balance as % of GNP	-0.45	0.96	-3.77	-1.88	0.48	-3.59	0.13	-0.08	2.93

Source: International Monetary Fund, Balance of Payment Statistics, adopted from Morris Goldstein, Donald J. Mathieson, and Timothy Lane (1991) 'Determinants and Systemic Consequences of International Capital Flows', IMF Occasional Paper 77, IMF, March.

[1] This is taken as the counterpart to the current account imbalance. A positive value indicates a capital account surplus (inflow).

[6] Such studies include that of Thirlwall (1994), Nadiri (1972), Robinson (1971), Correa (1970), and etc.

As shown in Table 1, large current account imbalances were evident in 1970-72 and 1979-81, net capital flows between the industrial countries expanded most rapidly after 1982. All the three countries experienced a far large capital inflow/(outflow) in 1985-88 than the two previous periods.

Various studies had been carried out to verify the effect of capital inflows on the economies of the recipient countries. Empirical results from the growth equation suggest that economic growth in the region has been most significantly related to export growth and growth in FDI (Wahyudi, 1990; Husain and Kwang, 1992). And based on the adoption of the empirical methodology developed by Lee, Rana and Iwasaki (1986), Hussain-Kwang's regression model found the effect of FDI on economic growth was positive and statistically significant in Asean countries.

2.3.2 The effects

The research of Mundell (1963) and Fleming (1962) have shown how important capital mobility is to the conduct of stabilization policy[7], and redirect attention towards the capital account and financial phenomena in general. Mundell assuming that there were capital mobility between domestic and foreign markets had postulated that:

1. monetary policy is ineffective in changing output under a fixed exchange rate regime because capital flows offset a monetary expansion and contraction; and
2. fiscal policy is ineffective in changing output under a flexible exchange rate regime because the exchange rate induces adjustments in the trade account which run counter to fiscal policy.

Whereas Fleming assuming capital mobility was imperfect had postulated that:

1. monetary policy is more effective in changing income and output under floating exchange rate regime than under a fixed exchange rate regime; and

[7] Stabilization policy here refers to monetary and fiscal policies.

2. fiscal policy is more effective in changing income, output and employment with a fixed exchange rate regime.

Various other researchers have stated that financial innovation, openness to and liberalization of international financial markets can impose severe constraints on the behavior of the economy and on the effectiveness of domestic economic policies (Hoffmeyer, 1978; Revira-Batiz, 1989, Goldstein *et al.,* 1991; BNM, 1997). For example, if a tight monetary policy was adopted to reduce money supply and increase interest rates, a large part of the effect would be offset by private sector borrowing from abroad. Whereas Goldstein *et al.* (1991) went on to point out that capital flows have responded to economic fundamentals[8], official policies[9], and market distortions[10]. The capital flows in the international capital markets can respond to a shock through changes in the prices of the country's financial claims, or through some combination of capital flows and asset price changes.

Dornbusch (1991) showed the problem of high capital mobility in an integrated asset market by looking at the 3 linkages between interest rate, the interaction of prices and the impact of real exchange rates on employment. The 3 linkages are:

(i) home interest rates are equal to those abroad, adjusted for anticipated depreciation and the risk premium that emerges from political and exchange rate risk. Thus, the home interest rates must be set high enough or savings will be transferred to foreign assets and the currency will come under attack;

(ii) domestic prices will be affected by the exchange rate: a rapid depreciation of the exchange rate will cause an increase in home inflation; and

[8] These economic fundamentals included the global investment opportunities available, the covariances between expected returns on various investments, the growth of wealth in different countries, and willingness to assume risk and in rates of time preference.

[9] The relevant official policies include tax policies; official guarantees; capital controls; limitations on the entry of foreign firms into domestic markets/activities; misaligned exchange rates; restrictive trade policies; and etc.

[10] Distortions in the operation of private markets such as transaction costs and asymmetric information among market participants that limits portfolio diversification or distorts asset prices.

(iii) a change in the (real) exchange rate will influence employment: in the long run, real depreciation is likely to raise employment.

Montes (1998) points out that equity and portfolio investments have overtaken direct investment, loans and trade credit in providing external financing in the 1990s. He cites Reisen's warning that foreign financing (capital inflows) should be resisted if they would 'cause unsustainable currency appreciation, excessive risk-taking in the banking system, and a sharp drop in private savings'.

There are many examples of capital flows which have led to exchange rate movements and thus raised complications for policy-makers. For instance, the US in 1980-85 experienced massive capital inflows that led to the appreciation of the dollar and an unprecedented shock to American manufacturing. And of course, shock can also run the other way when capital flight leads to a depreciation of the exchange rate and creates disturbances to the real economy of the countries concerned. Dependence on short-term capital flows pose more of a systemic risk (BNM, 1997; Musa, 1998) that can lead to exchange rate and liquidity crisis, when there is sharp reversal of such flows. Southeast Asian countries and Russia are just the latest real examples.

Other examples include the capital flight from Germany in the 1920s, Finland (1992), Chile (1982), and Mexico (1994). Goldfajn and Valdes (1997) showed that flows increase steadily up to a crisis and fall sharply in the year of the crisis for the following countries: Finland, Sweden, Chile, and Mexico.

Mussa (1998) has pointed out that world capital markets were pushing a large flood of capital into emerging markets that reached an annual rate of US$400 billion in the summer of 1997, in terms of gross flows. After the middle of August of 1998, these gross flows reached zero, just died completely. He contended that no country, no matter how soundly managed its economic policies are and how solid its banking system is, can maintain an open attitude towards international capital flows in the face of that type of systemic disturbance.

Therefore, the key to economic performance through debt financing via capital inflows is the ability to channel capital funds into domestic investment, while meeting their commitments on existing external debts and maintaining sound economic fundamentals.

2.4 Capital flows to developing countries

Following the standard classification adopted by the World Bank and OECD, capital flows to developing countries can be decomposed broadly into official flows and private flows.

As defined by Husain and Kwang (1992) and Wahyudi (1990), official flows include: (a) official grants from Governmentand Governmentagencies; (b) concessional loans from either bilateral or multilateral sources, and (c) non-concessional loans from either bilateral or multilateral sources, or export credit agencies. Private flows comprise: (a) commercial suppliers who provide export credits for purchase of goods; (b) commercial bank loans; (c) FDI; (d) other private flows such as portfolio investment; and (e) charitable organizations, which provide financial aid, goods and services as grants.

Capital flows to developing countries and transition economies have grown rapidly since the early 1990s due to expectations that rates of return in the developing countries would tend to be correspondingly higher (Wahyudi, 1990) and because of the need for portfolio diversification (Agarwal, 1980). Furthermore, the easing of capital controls and the broader liberalization of financial markets in these countries have also stimulated such flows. The magnitude and volatility of capital flows have presented both opportunities and challenges to the recipient countries, and much has been written about the causes, consequences, and policy implications of capital flows[11].

[11] For a recent summary, see Khan and Mathieson (1996).

Table 2 presents a breakdown of capital flows to developing countries. Figure 1 shows an increasing trend and share of private flows compared to official flows, whereas Figure 2 shows two important features in the figure: one is the dominance of FDI and the other is the rising share of portfolio flows in the 1990s. Thus it is clear that the private flows have became increasingly significant in international finance.

Table 2: Capital flows to Developing Countries, 1990 to 1996 (US$ billion)

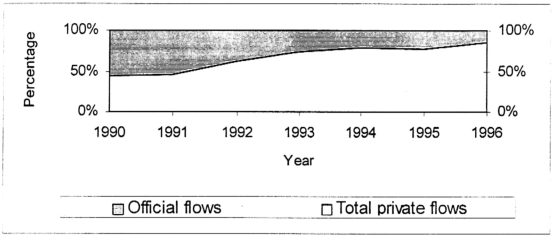
	1990	1991	1992	1993	1994	1995	1996*
Total flows	100.6	122.5	146.0	212.0	207.0	237.2	284.6
Official development finance	56.3	65.6	55.4	55.0	45.7	53.0	40.8
Grants	29.2	37.3	31.6	29.3	32.4	32.6	31.3
Loans	27.1	28.3	23.9	25.7	13.2	20.4	9.5
Total private flows	44.4	56.9	90.6	157.1	161.3	184.2	243.8
Debt flows	16.6	16.2	35.9	44.9	44.9	56.6	88.6
Commercial banks	3.0	2.8	12.5	-0.3	11.0	26.5	34.2
Bonds	2.3	10.1	9.9	35.9	29.3	28.5	46.1
Others	11.3	3.3	13.5	9.2	4.6	1.7	8.3
FDI	24.5	33.5	43.6	67.2	93.7	95.5	109.5
Portfolio equity	3.2	7.2	11.1	45.0	32.7	32.1	45.7

Note: Developing countries are defined as low and middle income countries with 1995 per capital income of less than US$765 (low) and US$9,385 (middle).

* Preliminary figures.

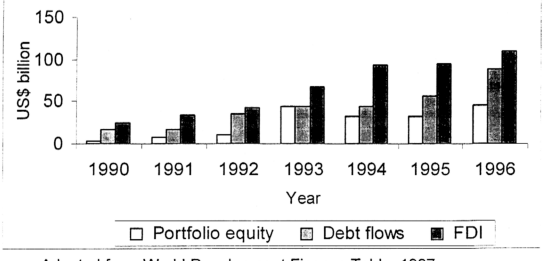
Source: World Bank, 1997, Global Development Finance.

Figure 1: Composition of private and official flows in developing countries, 1990-96.



Source: Adapted from World Development Finance Table, 1997

Figure 2: Composition of private flows in developing countries, 1990-96



Source: Adapted from World Development Finance Table, 1997

It is often argued that FDI is a desirable form of capital flows to the host countries. In contrast to portfolio investments that used to buy domestic financial assets, FDI flows for new plants, equipment and intermediate inputs have different macroeconomic implications. Montes (1998) argues that FDI has a limited impact on reserves, money supply and domestic interest rates; whereas Razin, Sadka and Yuen (1995) argues that FDI partners' direct managerial involvement can circumvent the financial market inefficiencies, and therefore may offer a cheaper alternative to portfolio financing. FDI can also increase a country's external collateral value, and help the transmission of information to foreign investors, thereby reducing the financing costs of debt and portfolio equity flows (Chen and Khan, 1997).

The World Investment Report 1998 of the United Nations Conference on Trade and Development (Unctad) states that FDI to South, East and Southeast Asia remains resilient despite the onset Asian financial crisis. The flows remain positive and continue to add to the capital stock of the region, which has grown from US$77.6 billion in 1996 to US$84.4 in 1997 (Unctad 1998).

Portfolio flows, however, are known to be difficult to cope with if the recipient country does not have well-developed macroeconomic policy instruments, or if the economy has fundamental weaknesses, such as a weak banking system (Khan and Reinhart, 1995). There is also a popular perception that portfolio flows are less stable than FDI. Turner (1991) and Roubini (1998) rank short-term bank lending as the most volatile and long-term bank flows as the least volatile, and followed by FDI. Claessens, Dooley and Warner (1995), however, argue that there is no statistical support for the practice of labeling various capital flow components as 'hot' or 'cold'. They find the components to be highly substitutable, with no evidence that a particular component can predict the aggregate flow. However, Chen and Khan (1997) exert that debt has long been recognized to provide an extra control on corporate governance.