eu•re•ka \yu̇-'rē-kə\ *interj* : Used to express triumph upon finding or discovering something in the Dow Jones Publications Library at

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Yes to Free Trade, Maybe to Capital Controls

By Jagdish Bhagwati, a professor of economics at Columbia University and former economic policy adviser to the director general of the General Agreement on Tariffs and Trade.

The Asian, and now international, financial crisis has led to a perception that the financial system has put capitalism itself at risk. Because of the role short-term capital flows played in precipitating the Asian crisis, many critics are calling for capital controls. Free-market types largely reject the idea of capital controls, seeing it as a form of protectionism. But the case for free capital flows and the case for free trade are not identical.

In fact, there is no compelling reason why if one is for free trade, one should also be for free direct foreign investment, or for free capital flows, or for free immigration, or for free anything for that matter. For reasons both political and economic, these different policies should be considered separately. The political point is obvious: The difficulties in winning support for free trade, free direct foreign investment and capital inflows, and free immigration rise as we go down that list.

On the economic dimension, free trade and free capital flows have striking differences, not just similarities. These differences reflect a unique downside to a policy of free capital flows.

The similarities between both policies are well understood. They relate to the upside of both trade and capital flows. Freeing both affirms the freedom to transact where and how one wishes. At the same time, any time you segment a market, you lose efficiency. Barriers to capital mobility thus carry the presumption of economic losses, just as barriers to trade do.

But here's the downside: Capital flows are subject to what the economic historian Charles Kindleberger of MIT has called "panics, manias and crashes." In a classic response to these concerns, Milton Friedman famously argued that speculative flows would tend to be "stabilizing," hence welfare-enhancing, because the speculators who betted against "fundamentals" would be wiped out in the marketplace. But the unfortunate fact is that speculation can be self-justifying: The fundamentals may change to reflect the speculation. Is this not what most likely happened when, out of panic, investors fled from what they perceived as weakened Asian economies, weakening them when they were originally strong?

The case for free trade is overwhelmingly powerful, thanks to both economic logic and the empirical demonstration of the postwar success with outward trade orientation. But if we are to back free capital mobility with the same confidence, we have to be assured on two counts. First, the costs of these crises should not be of the order seen in Indonesia. Second, the probability of such crises must be greatly and credibly diminished.

The costs of the crises to date have been unusually large. They were huge in Asian countries because substantial short-term inflows suddenly went into reverse. For the five countries--Indonesia, Malaysia, the Philippines, South Korea and Thailand--the effect was a loss of resources estimated at over 10% of their combined gross domestic product. Just recall the macroeconomic difficulties the U.S. went through in the 1970s, as increased oil prices led to a reduction in the nation's resources that was a mere 3% of GDP.

As these countries (except Malaysia) turned to the IMF, matters worsened. Excessively deflationary, and ignoring the strong fundamentals of basically sound economies, the IMF should have instead counseled reflation. So, to the inherent costs of a crisis, there were the gratuitous costs of mistakes by those whose job it is to assist during crisis.

But that is not all. The IMF fueled the panic by extravagant charges of "crony capitalism," "corruption" and every other sin in the Book of Virtue, going on to insist on "structural" reforms that had little to do with the crisis. So it also began the era of unwarranted intrusion into economic choices that are properly within the crisis-afflicted countries' sovereign domain.

But if these economic and political costs of crises are big, the chance of successfully changing the Bretton Woods infrastructure to make such crises improbable is small. The recent IMF-World Bank meetings in Washington revealed agreement on the easy issues. Who could oppose apple-pie demands for "transparency" and better banking standards and supervision? But it also demonstrated fundamental division on difficult issues, such as the choice between fixed and flexible exchange rate regimes as antidotes to financial and currency crises, and whether the IMF is the problem (as former Secretary of State George Shultz and economist Allan Meltzer argue) or the solution (as Treasury Secretary Robert Rubin and his deputy, Lawrence Summers, believe).

Facing this reality, and recognizing that zealous overconfidence in announcing the end of the crises has never been in short supply, I believe that prudence and caution concerning free capital mobility are in order. For many developing countries today, including India and China, the question is not whether to impose capital controls but whether to drop them. To them, I say: Cease moving toward free capital flows until you have political stability, sustained prosperity and substantial macroeconomic expertise. Concentrate instead on internal reforms such as privatization and external reforms such as freer trade. Allow "targeted" convertibility for dividends, profits and invested capital for direct foreign investment. It brings capital and skills and is more stable than short-term capital flows.

For the countries that had already freed capital flows substantially and are currently afflicted by panic-driven outflows, my advice is the opposite: Do not jump into capital controls.

These countries need to restore confidence. The imposition of capital controls, as in Malaysia, would not establish, and could easily undermine, that confidence. True, you can lower interest rates with capital controls and hope to revive the economy quickly. But this textbook analysis ignores the obvious: If diffidence has increased, who will borrow to invest?

They should rather stay the course, eschewing capital controls whose efficacy, in any event, is likely to be short-lived--since playing the game of capital-account convertibility has already produced players who have the knowledge and expertise to evade the controls.

And when back on track with capital account convertibility, these countries need to learn from their recent afflictions that they must be prudent, watching their short-term debt exposure and being prepared

to regulate and moderate it as necessary. In short, gung-ho financial capitalism, letting capital flows rip, is far too risky--a sure-fire way of betting the company.

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