So what's the upside of financial globalisation?

By Dani Rodrik

SOMETHING is amiss in the world of finance. The problem is not another financial meltdown in an emerging market, with the predictable contagion that engulfs neighbouring countries. Even the most exposed countries handled the last round of financial shocks, in May and June last year, relatively comfortably. Instead, the problem this time around is one that relatively calm times have helped reveal: The predicted benefits of financial globalisation are nowhere to be seen.

Financial globalisation is a recent phenomenon. One could trace its beginnings to the 1970s, when recycled petrodollars fuelled large capital inflows to developing nations. But it was only around 1990 that most emerging markets threw caution to the wind and removed controls on private portfolio and bank flows. Private capital flows have exploded since, dwarfing trade in goods and services. So the world has experienced true financial globalisation only for 15 years or so.

Freeing up capital flows had an inexorable logic - or so it seemed. Developing nations, the argument went, have plenty of investment opportunities, but are short of savings. Foreign capital inflows would allow them to draw on the savings of rich countries, increase their investment rates and stimulate growth. In addition, financial globalisation would allow poor nations to smooth out the boom-and-bust cycles associated with temporary terms-of-trade shocks and other bouts of bad luck. Finally, exposure to the discipline of financial markets would make it harder for profligate governments to misbehave.

But things have not worked out according to plan. Research at the International Monetary Fund, of all places, as well as by independent scholars documents a number of puzzles and paradoxes. For example, it is difficult to find evidence that countries that freed up capital flows have experienced sustained economic growth as a result. In fact, many emerging markets experienced declines in investment rates. Nor, on balance, has liberalisation of capital flows stabilised consumption.

Most intriguingly, the countries that have done the best in recent years are those that relied the least on foreign financing. China, the world's growth superstar, has a huge current-account surplus, which means that it is a net lender to the rest of the world. Among other high-growth countries, Vietnam's current account is essentially balanced, and India has only a small deficit. Latin America, Argentina and Brazil have been running comfortable external surpluses recently. In fact, their new-found resilience to capital-market shocks is due in no small part to their becoming net lenders to the rest of the world, after years as net borrowers.
To understand what is going on, we need a different explanation of what keeps investment and growth low in most poor nations. Whereas the standard story - the one that motivated the drive to liberalise capital flows - is that developing countries are saving-constrained, the fact that capital is moving outward rather than inward in the most successful developing countries suggests that the constraint lies elsewhere. Most likely, the real constraint lies on the investment side.

The main problem seems to be the paucity of entrepreneurship and low propensity to invest in plants and equipment - what John Maynard Keynes called 'low animal spirits' - especially to raise output of products that can be traded on world markets. Behind this shortcoming lay various institutional and market distortions associated with industrial and other modern-sector activities in low-income environments.

When countries suffer from low investment demand, freeing up capital inflows does not do much good. What businesses in these countries need is not necessarily more finance, but the expectation of larger profits for their owners. In fact, capital inflows can make things worse, because they tend to appreciate the domestic currency and make production in export activities less profitable, further weakening the incentive to invest.

Thus, the pattern in emerging market economies that liberalised capital inflows has been lower investment in the modern sectors of the economy, and eventually slower economic growth once the consumption boom associated with the capital inflows plays out.

By contrast, countries like China and India, which avoided a surge of capital inflows, managed to maintain highly competitive domestic currencies, and thereby kept profitability and investment high.

The lesson for countries that have not yet made the leap to financial globalisation is clear: Beware. Nothing can kill growth more effectively than an uncompetitive currency, and there is no faster route to currency appreciation than a surge in capital inflows.

For those countries that have already made the leap, the choices are more difficult. Managing the exchange rate becomes much more difficult when capital is free to come and go as it pleases. But it is not impossible - as long as policymakers understand the critical role played by the exchange rate and the need to subordinate capital flows to the requirements of competitiveness.

Given all the effort that the world's 'emerging markets' have devoted to shielding themselves from financial volatility, they have reason to ask: Where in the world is the upside of financial liberalisation? That is a question all of us should consider.

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