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Global Capital Flows: No Textbook Solution
by Jane Skanderup

As the world's economic leaders prepare to gather next week for the annual World Bank and International Monetary Fund (IMF) meetings in Washington, D.C., all eyes scan the global economy for new surprises and perils. As countries wage old and new battles against jittery international investors, economic sages are sharpening their intellectual weapons debating the causes and cures. The "worst financial crisis since the Depression," as President Clinton characterized it, is notable not only for the challenges facing the "patients," but for the crisis attending the "doctors" themselves.

With Asia in recession, and the Russian crisis bearing down heavily on Brazil, critics of the IMF's tight money policies are growing more numerous every day. Chairman of the U.S. Federal Reserve, Alan Greenspan, admitted during Congressional testimony in September that "I think [the IMF] misread the depth of some of the really fundamental problems that were involved in the crisis that evolved...I think their actions were somewhat misguided in the early stages."

The IMF argues that it has altered policy guidance in the face of emerging new realities, and that its advice has at times been implemented incorrectly. Yet the crisis has engendered the most serious challenge to economic orthodoxy since the Depression. Notable among the many debates is a much broader acceptance of capital controls, and a new appreciation of how the process of liberalizing capital accounts does matter. The IMF and the World Bank have been at the center of these two issues, and the meetings next week offer an opportunity for the world's leading economic actors and thinkers to stem the erosion of confidence in the global economic architecture.

When Malaysia imposed capital controls on September 1, the reaction from investment fund managers was predictable. "It amounts to a theft of assets," said Mark Mobius of Templeton Emerging Markets Fund, adding "If this spreads, the international financial markets will freeze." A muted response from the U.S. Treasury and stronger language from Japan also argued against the move. But along with the widely-quoted MIT professor Paul Krugman who has called for the imposition of controls – albeit limited and carefully designed ones – World Bank Vice President Joseph Stiglitz also agrees that some controls on short-term capital are now inevitable. The question is how to deter short-term capital flight without harming long-term foreign direct investment (FDI) and the ease of currency convertibility that both investment and trade requires.

Chile has used controls effectively for some time, although compared with Malaysia the policy is mild: 30% of short-term foreign investment is required to be kept on interest-free deposit with the Central Bank for one year. This is a far cry from non-convertibility of the Malaysian ringgit outside of the country for one year, and critics argue that in addition to other ills – especially that controls will delay the restructuring process – it will encourage exporters to park export proceeds overseas, which could induce a balance of payments problem and cause the government to establish a new currency rate. This is why controls over a long period of time can bring more unpredictability than the disease they were meant to cure.

IMF Managing Director Michel Camdessus has acknowledged that "These are difficult times, and times when the temptation is strong to go it alone, and to try to escape from the constraints or to go to any kind of policy." Speaking after an IMF-sponsored "regional surveillance" meeting of finance ministers and central bank governors of 11 Latin American countries in early September -- just as the Russian crisis was spilling into the region -- Camdessus added that among the gathered officials there was a joint and firm commitment to further the economic reform process and resist the "go it alone" route.

As the international markets continue to punish the Brazilian *real* in days since, President Cardoso has called for industrialized nations to set up a "contingency fund" for Latin America, that presumably would provide funds more quickly than complicated deals now under discussion. This is reminiscent of Japan's proposal at last year's IMF/World Bank meetings to establish an

Asian fund that was effectively squashed by IMF and U.S. Treasury officials.

At the opposite end of the debate over controls is how to open up an economy to international financial flows in the first place. And here, the Asian experience has taught that there is a right and a wrong way. South Korea is a perfect example: in order to gain membership in the Organization of Economic Cooperation and Development (OECD) in December 1996, South Korea pledged capital account liberalization but found deregulation of long-term foreign direct investment (FDI) too challenging, so it opened up short-term flows at a faster rate. And no wonder it was challenging: next to Japan, South Korea was one of the most closed economies to FDI in Asia, with FDI making up just 0.93% of all investment in the ROK between 1992-97, according to a pre-crisis IMF study that urged South Korea to liberalize FDI. South Korea's share was higher than Japan with 0.068%, but significantly lower than 25% in Singapore, 18% in Malaysia, 13% in China, and 4% for the United States.

In just six months since it nearly defaulted on mounting bank debt in December 1997, South Korea has vastly opened up sectors of the economy to FDI, including allowing both friendly and hostile mergers and acquisitions (M&As), still unheard of in most of Asia. As a result, FDI through June totaled $662 million, a 25% increase over June 1997 – and nearly 30% of that was through M&As compared to 10% the year before. This is good news: the ROK's FDI pattern is beginning to approach the global FDI pattern where 85% of flows occur through M&As. Indeed, this strongly argues for liberalization of FDI regulations to attract investment that is more rooted in the economy than "hot" money flows. Of course, although South Korea has succeeded in changing many laws, changing practices is quite another matter, and South Koreans know that more needs to be done to "treat Korea IBM as more Korean than Daewoo Germany," as President DJ Kim has urged.

But only now do we know that South Korea's choice of its capital liberalization process was a big mistake. The IMF is, in fact, soliciting views from various quarters to assess the advisability of adding capital account liberalization to its charter that would effectively give it jurisdiction over members' capital accounts. Although everyone agrees that access to international financial markets is essential for developing and developed countries alike, there are distinct views on whether preconditions – such as effective banking supervision and strong financial institutions – are first necessary to avoid external volatility from weakening the domestic economy. Or would preconditions simply allow countries to delay difficult decisions? South Korea's experience suggests that structural reform may, in fact, occur only when forced. But as a UK Treasury official rightly noted, "This is not an area in which developed and developing countries should divide. There is a common interest in getting it right."

This division is a real possibility. As economies wage their daily battles and the economic sages wage theirs, the sense of unfairness and inequity in the global economic system is strong and growing, especially in emerging economies. Domestic structural reform is important and will yield positive results in more competitive economies. Yet altering decades of established behavior – in essence reshaping the way economic society interacts – will take time. Meanwhile, the IMF and World Bank are the only international institutions we have, and they need all the help they can get in developing a consensus on addressing weaknesses in the global economy.

Jane Skanderup is Assistant Director for Programs and Development at the Pacific Forum CSIS. This article draws on the study she recently completed with Stephen Canner on the OECD Multilateral Agreement on Investment and prospective impacts on South Korea.