

General Discussion: Patterns of International Capital Flows and Their Implications for Economic Development

Chair: R. Glenn Hubbard

Mr. Meltzer: I think this is an interesting and important set of issues, and it is a thought-provoking paper. It certainly provoked me.

A question is, Why are countries developing surpluses as part of their growth? The word mercantilism didn't get mentioned—and yet it is hard to think of China or most of Asia without thinking about mercantilism. Mercantilism takes the form of export-like growth in the modern era. That is certainly something that has to do with the Asian countries accumulating enormous current-account surpluses, for example, almost a trillion dollars in China. That doesn't sound like a market response by the Chinese to what is going on; it sounds more like a subsidy to the exports to the United States and Europe.

In addition to this mercantilist policy, they have rigid capital controls on the real exchange rate to prevent the inflationary effects and the appreciation you talk about. They prevent that from happening in China and in other Asian countries, which link their exchange rates similarly to China. They prevent appreciation and inflation by rigid capital controls.

That seems to me to be a big part of the story about why they have large surpluses. They have them because they want them. They want

them because they want to subsidize the exports that are giving them the current account balance.

If they opened the economy and had a capital outflow, certainly things would change. Some people think they would actually end up in the position that you think. The capital outflow would be large enough to offset these effects. But certainly that is a factor that one needs to look at.

A final brief comment: I found interesting the work that you have on capital accumulation and growth. I don't know about the other countries, but certainly one knows there is an enormous waste of resources in China's investment policies. That might explain why investment has such a tenuous effect to growth. In any case, it ought to be explored.

Mr. Fischer: I have three brief comments. First, on the relationship between foreign direct investment (FDI) and growth: If you have any data on rates of return on FDI, they would shed light on the association between growth and FDI.

The second comment is about the argument that liberalizing inward capital flows can cause the Dutch disease. That's true. But it is also true that liberalizing capital outflows can help avoid the Dutch disease. Incidentally, differences in the extent of outward liberalization also could be used as in studying the impact of the opening on the current account.

Finally, I have a comment on a point that Susan Collins raised. We used to have a standing argument in the monetary economics course that Franco Modigliani and I taught jointly. He always asserted that the life-cycle hypothesis implied a positive correlation between growth as the exogenous variable and the savings rate. I thought theory made the impact ambiguous, but since Franco made the point, I was probably wrong.

Mr. Srinivasan: I have two brief points. Mr. Rajan, you mentioned in your presentation that you are essentially interpreting partial calculations. But all your interpretations seem to be structural. One

explanation was not posited against another explanation. See how the two explanations fared against each other in the data. Without a structural model motivated by a sound theory, I don't know what one can infer from these kinds of cross-country regressions. Most of the capital flow theories are based on a risk-adjusted rate of return to capital. None of these regressions have anything to do with any rate of return measure at all. I don't understand how correlating the rate of growth of the gross domestic product (GDP), on one hand, and absolute magnitude of current account surpluses deficit is going to say anything about underlying rates of return.

Think of Botswana, which has been growing rapidly and more or less at the same rate as India has been growing in the last 20 years. Would you expect them to have the same current account quantitative magnitude? I don't see what this kind of story implies. I don't know what to infer from it.

The second thing is, in the aggregate, you don't distinguish in many countries between the public sector, public investment, or public savings. It is an important element of the whole story. That is different from what the situation is with respect to the private sector. Not distinguishing between the two and thinking in terms of aggregate once again, I don't see much that you can learn about moderation.

The last point is about the time balance sheet. Again, think of the reserve accumulation. One can easily postulate the reserve accumulation is a short-term response to the phenomenon that you mentioned—the financial system not being developed, the investment climate currently not being adequate. While that is being addressed, you keep the money in reserves. And then once you address them, you draw it down. Without thinking through the cycle this goes through, I don't know what you can infer from all this.

Mr. Mishkin: I'd like to focus on policy implications. One of the important things in this paper is the fact that capital is flowing uphill and the fact that countries which do not have large capital inflows actually seem to do better. One view then might be that you don't need to open up your capital market because this capital inflow isn't

helping much. The paper is actually showing the opposite. In fact, Raghuraj Rajan has a book that is very much an advocate of opening up capital markets, and I have a recent book that takes the same position—that is really the key lesson from the paper.

The key point of the paper is that the reason capital flows uphill is because of undeveloped financial systems. These countries are better off putting their money in the United States than keeping it there.

On the other hand, there is this issue of why it would be important to open up your markets to both trade and capital. The key to understanding this is that institutional financial development is the way that countries get rich.

When you look at why countries are doing well in terms of high growth, it turns out that total factor productivity (TFP) growth is the key. In fact, TFP growth is telling you that the way capital is allocated is important. Just throwing money at the country, either by capital inflows or foreign aid, can make things worse off. We see many examples of exactly that.

On the other hand, opening up your capital markets can drive competition, which creates a demand for improving institutions. Indeed, there is now a lot of research telling us that both institutions and financial development really rule. If you don't do a good job of allocating capital to productive investments, you are never going to get rich. One of the major contributions of this paper is to show that the fact that countries which import a lot of capital don't do better is really an indication of how important it is to get these institutional financial development issues right.

Mr. Kohn: I have two points. One question is about the relationship of the increase in productivity and high savings rates. One of the factors that is said to have generated high savings rates in the poorer countries is the lack of or the reduced provision of government services for retirement, education, and medical services. I can see that with a productivity shock, my taste for these things would rise. If the

government wasn't providing them, then my savings rate would rise. I wondered whether you would comment on that.

The second point is that I have another possible channel linking weak financial markets to surpluses, particularly in recent years. That is, with weak financial sectors, monetary policy cannot be very effective. In 2000-2004, when global demand was weak, in order to keep poorer countries or industrializing countries employed, you had to keep your exchange rate undervalued. It wasn't as much about preventing overvaluation; it was keeping it undervalued because monetary policy wouldn't have been effective in stimulating domestic demand. Now that global demand has increased, it will be interesting to see whether the need for upward pressure on these currencies and downward pressure on their surpluses for macroeconomic stability reasons also will be increasing.

Ms. Woodall: I wonder whether the fact that the composition of emerging economies' current account surplus has changed in recent years affects the analysis. Most people still think it is the Asian economies that are driving the emerging economies' total surplus. But, in fact, the International Monetary Fund's (IMF's) own figures in the *World Economic Outlook* show now that something like three-quarters of the total surplus of the emerging economies is from the oil producers. Does the fact that most of the increase in the surplus over the past five to six years has been contributed by the oil producers affect the analysis?

Mr. Rajan: I don't have much to say to Susan, except that this was a well-thought-out discussion, and there are lots of suggestions that we intend to take up. Clearly, this is a first pass, determined by limitations of time and the deadline to get the paper in. There is a lot more work that needs to go in, including more careful thought about some of these factors.

Allan Meltzer's point about mercantilism is quite possible. But one of the things we did, which is not in the paper, was look at overvaluation versus undervaluation. Are the guys who are undervalued

growing faster? It isn't that overvaluation hurts you, but there isn't strong evidence that undervaluation helps you. We know a number of reasons why undervaluation need not help you. Those data are not strong. That is why it is not in the paper. It doesn't jump out at you. We haven't touched on that, but it certainly is an issue.

On Stan Fischer's question, the rates of return for FDI would be useful. We've done some work at the IMF recently in trying to estimate the domestic returns to investment. I have to say it is a difficult task, so I am not sure whether it will be easy to get the rates of return on FDI. But we will look at that.

For T.N. Srinivasan's question, I will give Arvind Subramanian a chance to offer a more detailed response. Think about this as trying to look at the data in different ways. My sense is if you look at the data, you get more information. That can enable you to craft better theories and perhaps craft better tests. I don't think that not looking at the data is the way to go because you can't do a strict structural model of analysis. Many policymakers would say when you can't set off with this wonderful structural model, at least tell me what the data say so I can get a handle on what might be plausible theory. In a sense, think of this paper as that.

I agree with Ric Mishkin. Our point is not to say that capital account opening is a bad thing. It is to say that when you are doing it, know that the growth effects are now going to be immediate. They are going to be largely institutional. Have a way of explaining it to the population, saying, "These are the collateral benefits"—much along the line that Ken Rogoff and Eswar Prasad's paper suggests. That is the way it is going to be. That is also the point of the book we wrote. The collateral institutional benefits are probably going to be higher from capital account opening.

On Don Kohn's point, I think the lack of a safety net may explain some higher savings in China. It's less clear that is the case in emerging Asia. However, there is a related explanation, which is given the

crisis and fact they lost jobs, there is not much of an unemployment safety net. Perhaps that contributed to the sense that they needed higher savings, and that may have contributed to the savings rate there. I agree with your point about monetary policy.

Ms. Woodall, much of our analysis ends in 2000, before the large rise in surpluses from the oil exporters. I don't think it will change our basic conclusions. In fact, if we restrict the entire analysis from 1985 to 1997 (before the Asian crisis), the results basically go through qualitatively. In that sense, it is not a recent phenomenon.

Arvind, would you like to comment?

Mr. Subramanian: I would like to clarify one comment that T.N. made about Botswana and India. All the current account measures are scaled by GDP, so it is not a natural current account.

And your point about distinguishing public and private savings is a good one. That is something we should pursue in future work.