The Other Side **June 18, 2015**

CAC and Economic Growth

In the last article (June 4th), I had referred to several cases of balance of payments crises arising from excess capital inflows, and its corollary, overvalued exchange rates. I had also quoted Prof. Jagdish Bhagwati and Nobel Laureate James Tobin criticising the IMFs pursuit of a liberal capital account as, respectively, an ***"unwarranted extrapolation from free trade, resulting in freed international capital flows****"* and describing "***South Koreans and other Asian countries—like Mexico in 1994-95"*** as ***"victims of a flawed international exchange rate system that, under US leadership, gives the mobility of capital priority .. over all other considerations'.*** (This reminds me how, in an earlier era, China was forced to import opium, and grain exported from Ireland despite a raging famine, under the guise of the holy principle of free trade.)

Data quoted earlier (May 21st) suggests a very strong correlation between liberal capital accounts and financial crises. Obviously, there are risks in full capital account convertibility – and sudden reversal of flows. Are the risks adequately compensated by rewards in terms of stronger economic growth? There is not much supporting evidence that a liberal capital account helps growth. To quote from Dr. Raghuram Rajan's *Fault Lines*, "*We found a positive correlation for developing countries: the more* ***a country finances its investment through its own domestic savings, the faster it grows****. Conversely, the more foreign financing it uses, the more slowly it grows."* The reason could well be that "*given the liquidity of their assets, the holders of financial assets are too quick to respond to change, which makes it difficult for real-sector companies to secure the 'patient capital' that they need for long-term development. The speed gap between the financial sector and the real sector needs to be reduced, which means that* ***the financial market needs to be deliberately made less efficient."*** (*23 Things They Don't Tell You About Capitalism* by Ha-Joon Chang.) Barry Eichengreen has concluded that, *"History has also shown that* (capital flows) *can be dangerously unstable"* (*Capital Mobility: Ties Need Not Bind).* Paul Davidson has argued that "***there is no way of distinguishing between the movement of funds being used to promote genuine real investment for***

developing the world's resources and funds that take refuge in one nation's money after another in the continuous search for ….. speculative gains'" (*Financial Markets, Money and the Real World*). Khairy Tourk, Professor of Economics, Stewart School of Business, Chicago, in a letter to the Financial Times (March 10, 2012), wrote about the crisis in East Asia that "***The 1997 crisis, on the other hand, was a result of an International Monetary Fund policy that reflected Wall Street interests."*** As Ben Bernanke conceded in a 2011 speech "***we have seen a number of episodes in which international capital flows have brought with them challenges for macroeconomic adjustment, financial stability, or both…… The Asian crisis imposed heavy costs in terms of financial and macroeconomic instability in the affected countries….***"

An IMF research paper by Eswar Prasad *et al* "*Effects of Financial Globalisation on Developing Countries"* (2003) also finds that "*the process of capital account liberalization appears to have been accompanied in some cases by increased vulnerability to crises*". Another background paper published by the IMF (*Liberalising Capital Flows and Managing Outflows,* March, 2012) also concedes most of the points made in this article:

⇒ *The empirical evidence on the benefits of liberalizing capital flows is fairly mixed.*

⇒ *The main cost of capital flow liberalization is vulnerability to financial crises brought on by large and volatile capital flows.*

⇒ *A welfare theory approach developed recently emphasizes sudden stops and the real disruptions associated with capital flows.*

On the other hand, the IMF's Institutional View (2012) is quite different. It claims that on the basis of an economic analysis of 37 countries which liberalized capital flows between 1995 and 2010 (from Afghanistan to Uganda, the only two major economies in the sample being Korea and Russia), liberalization is associated with "higher real GDP growth per capita", "lower inflation rate" "higher equity returns", "lower bank capital adequacy ratios", and "higher capital inflows and outflows". There is no reference to China, for example, registering higher growth than every country in the sample without a liberal capital account. And, surely Russia's growth had more to do with the oil price than capital account liberalisation. Afghanistan – the less said the better!

The IMF's own *Independent Evaluation Office (IEO)* has conceded that "*The IMF's ability to correctly identify the mounting risks was* ***hindered by a high degree of groupthink, intellectual capture, ...*** *senior staff members* ***felt that expressing strong contrarian views could 'ruin one's career'.*** *Thus, views tended to* 'gravitate toward the middle*' and '***our advice becomes procyclical**.*' Staff saw that conforming assessments were not penalized, even if proven faulty."* (January 2011).

Another IEO Report (May 2011), *"Research at the IMF: Relevance and Utilisation"* makes the point equally bluntly: "*there is a widely held perception that IMF research is* ***message driven****. About half of the authorities held this view, and* ***more than half of the staff indicated that they felt pressure to align their conclusions with IMF policies and positions****.* ***Policy recommendations*** *provided in some research publications* ***did not follow from the research results*** *… IMF research tended to follow a pre-set view with predictable conclusions that did not allow for alternative perspectives.*"

Article IV of the IMF's Articles of Agreement commit members to follow policies to promote growth and financial stability – does CAC promote either?

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