THE AMERICAS AND INTERNATIONAL ECONOMY: IMF economists shift debate over capital controls

Financial Times
August 21, 2006

Countries need to develop well-functioning institutions and reasonably mature domestic capital markets before they can benefit from capital account liberalisation, according to a study conducted by present and former officials of the International Monetary Fund.

These conditions are among a list of factors that research suggests have to be met for capital account liberalisation to boost growth and productivity, and diminish the risk of financial crises. The other conditions include decent corporate governance, appropriate economic and exchange rate policies and openness to trade.

The study - by senior IMF economists Ayhan Kose, Eswar Prasad and Shang-Jin Wei, and former IMF chief economist Ken Rogoff - does not represent official IMF policy.

But it reflects a shift in the global debate over capital account liberalisation, away from arguing whether opening up the capital account is good or bad for developing countries, towards examining what conditions it needs to meet to deliver positive results.

This is directly relevant to China and to other developing countries that are growing rapidly but maintain capital controls.

The IMF was once firmly in favour of capital account liberalisation, but has progressively qualified this position since the 1997 Asian crisis.

The bottom line, the report argues, is that some of the extreme polemical claims made about the effects of financial globalisation on developing countries are far less easy to substantiate than either side generally cares to admit.

It finds little hard macro-economic evidence that developing countries with open capital account regimes grow faster, but it also finds similarly little evidence that they are more prone to crises. There is, though, some evidence that countries that actually have significant crossborder financial flows grow a bit faster on
average, and microeconomic studies of individual companies and sectors show positive effects on output growth.

Traditionally, advocates of capital account liberalisation argue that it allows developing countries to access more capital, improves the capital allocation process and allows for international risk-sharing.

But the new report suggests that these may be less important than indirect or collateral benefits - including stronger financial markets, institutions, governance and more macro-economic discipline, stimulated by openness to foreign capital.

The problem is that these factors need to be at a reasonable stage of development before a country opens up its capital account. If the capital account is opened prematurely, the benefits are mitigated and the risk of crisis goes up.