Capital flows: A force for good VIEWPOINT BUSINESS ASIA by Bloomberg

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With China and India slowly easing controls on capital inflows and outflows, the risks and rewards of financial globalization are once again in the spotlight. Now that two of the world's most dynamic economies have decided to walk the arduous and perhaps long road to full currency convertibility, economists are working hard to fill the gaping hole in our (and their) knowledge about the linkages between capital mobility, economic growth and financial crises. The latest effort in this direction is by the International Monetary Fund researchers M. Ayhan Kose, **Eswar Prasad** and Shang-Jin Wei, who, together with a former colleague and Harvard University economist, Kenneth Rogoff, published their study on the subject Monday. The report, titled "Financial Globalization: A Reappraisal," is not the IMF's official view on the subject.

Still, I'll be surprised if it doesn't play a role in the discussions on the Fund's new mandate for currency surveillance when the boards of governors of both the IMF and the World Bank Group meet in Singapore next month.

The IMF is hesitant to take issues related to capital accounts under its jurisdiction because of the absence of firm theoretical and empirical conclusions about the costs and benefits of unhindered investment flows.

This reluctance is increasingly untenable. Last year, the IMF's Independent Evaluation office said "to the extent that capital account policy is intimately connected with exchange rate policy," there ought to be more clarity in the Fund's approach to financial globalization.

Since the days of Adam Smith and David Ricardo, there has been little disagreement among economists that greater international movement of goods is a good thing. It's only when the same logic is extended to the flow of debt and equity that academic unity breaks down, with some of the staunchest proponents of free trade revealing themselves as virulent critics of capital account liberalization. The desirability of a world in which capital moves freely is "the prevalent myth," Jagdish Bhagwati, an economist at Columbia University, said in a May 1998 article published in Foreign Affairs. The Asian crisis, said Bhagwati, had shown that, unlike trade in widgets, trade in dollars was extremely risky. Eight years later, the defenders of capital mobility are still searching for hard evidence to prove the doubters wrong. Now there's a growing intuitive feeling that the critics have unfairly dismissed "a strong force for the good," as Frederic Mishkin, an economist at Columbia University's business school, described financial globalization in a paper last year.

In the latest study on the subject, the IMF researchers argued that, contrary to the traditional view, capital account convertibility isn't simply about supplementing domestic savings with enhanced access to investment from abroad. What's more important are the indirect, or "collateral," benefits. Better banks, stronger capital markets and more robust macroeconomic policies follow from the discipline imposed by unfettered capital flows, the researchers said. Meanwhile, policy makers in China and India seem to be convinced of the need for full convertibility. China, which maintains that a fully convertible currency is the ultimate goal of the "reform" of its exchange rate system,

recently allowed eight banks, including Industrial & Commercial Bank of China, Bank of China, Citigroup and HSBC Holdings, to invest $8.8 billion worth of yuan deposits overseas.

This move, which has elicited only a lukewarm response from Chinese savers, followed greater flexibility for domestic companies to invest overseas and more room for selected foreign institutional investors to buy local-currency-denominated shares.

India doesn't allow individual foreigners or hedge funds to buy local shares directly. Debt denominated in Indian rupees is out of bounds for overseas institutions beyond a measly limit of $3.5 billion in total. Residents can only take $25,000 out of the country in a year. The government, which doesn't itself borrow abroad, prevents local companies from running up too much foreign-currency debt.

"There's merit in moving toward fuller capital account convertibility," Prime Minister Manmohan Singh of India said in March. Subsequently, a panel was set up to draw a road map for dismantling capital controls. The committee's advice, submitted to the central bank on July 31, has yet to be made public.

Interestingly, both India and China could be motivated more by the "collateral" benefits of capital account convertibility than by purely traditional ones. India's move, for instance, is closely linked to developing Mumbai into a regional financial center in Asia. Also, once local savings can be sent abroad more freely, the Indian government will have to keep tight limits on its spending in order not to spark capital flight. This discipline, enforced by the market, will improve the creditworthiness of Indian corporate borrowers internationally.

Similarly, every little step China is taking toward a convertible currency could be part of the policy makers' larger ambition to usher in a modern, well-functioning financial system. China hasn't given a time frame for full convertibility. Some analysts expect the project to be completed by 2010; others say it will take decades, not years. Yet the general direction of change is unmistakable. It seems policy makers in China and India understand better than academia that trade integration inevitably and increasingly gnaws at capital controls. Beyond a point, holding on to a defense mechanism that buys little protection will be just excessive self-denial.