
Globalization and Capital Account Liberalization

*T. Ademola Oyejide **

I. Introduction

Mainstream literature generally encourages developing countries to take advantage of the opportunities offered by the process of globalization to enhance the rapid and sustainable growth of their economies. Since the globalization process involves general liberalization of a range of economic policies as a means of harvesting the dividends of these opportunities, there exists considerable research and policy interest in seeking a fuller understanding of the links between the process of globalization and capital account liberalization. This is not an easy task. The globalization process manifests itself in many different ways and while these may bring opportunities, it is generally recognized that an economy's exposure to the process is not without significant risks. In addition and in spite of years of concerted analytical and empirical analysis, capital account liberalization remains an area in which there is little professional consensus (IEO, 2005).

This paper reviews some aspects of the debate on the linkages between globalization and capital account liberalization. In doing this, the paper starts with an analysis of globalization and the associated capital flows in section II; and then discusses the impact of the capital flows on the financial and real sectors of the economy. Capital flows create their own unique policy challenges. Hence, section III of this paper addresses issues relating to the management of capital flows by identifying and discussing a menu of policy options. Capital account liberalization also has an important role in the management of capital flows, but the process of capital account liberalization

** Professor of Economics and Director, Trade Policy Research and Training Programme (TPRTP), Department of Economics, University of Ibadan, Ibadan. E-mail: adeoyejide@yahoo.com.uk The views expressed herein do not represent the views of the institution to which he is affiliated. The author acknowledges the comments and suggestions of anonymous reviewers.*

itself requires to be managed. Section IV is therefore devoted to an analysis of these two aspects. The paper's concluding comments are offered in section V.

II. Globalization, Capital Flows and their Impact

Globalization, as a process, is a complex and multi-dimensional phenomenon, but some of its most visible and influential elements are economic in nature (ECLA, 2002). In its economic dimension, this process is characterized by increasing flows of trade in goods and services among countries and as a share of their gross domestic products, as well as similar flows in the factors of production, particularly capital and technology. In other words, globalization could involve trade booms, huge capital flows, and mass migrations (Richardson, 1995).

In essence, therefore, the globalization process generally involves the deepening and widening of cross-border flows of trade, capital, labour and technology which are facilitated by rapid communication mechanisms. In effect, innovations in communications and information technology combined with the liberalization and deregulation of the markets and economies of many countries have played the key role of fostering global economic integration by boosting trade and investment flows. The belief that the resulting freer flows of trade and investment in the global context will produce the best outcome for economic growth and human welfare is increasingly pressurizing governments of developing countries to further liberalize their economic policies and regulatory regimes so as to align them more closely with those prevailing in the more industrialized high-income countries.

There is clear evidence that the globalization process has been under way for sometime. Since the 1970s, for instance, international trade, investment and technology flows have been large and rising. In particular, the ratio of trade to output has risen markedly virtually world-wide; global trade has grown twelve-fold, foreign direct investment (FDI) flows have increased approximately 32-fold, and the linkages between trade and capital flows are strengthening as more and more FDI flows are geared to serving global rather than domestic markets and are increasingly attracted into rapidly growing and

export-oriented economies. More recent estimates show that net private capital flows to developing countries grew from less than \$100 billion in 1990 to well over \$200 billion in 1995 (IEO, 2005). But subsequent years saw an equally large reversal of these flows so that the volume remained subdued through the 2000-2005 period.

Capital flows differ quite markedly, particularly in terms of volatility. Because certain forms of these flows (e.g. portfolio investment) are volatile, they can constitute a significant source of macro-economic disturbance. The possibility exists that such forms of capital inflows could abruptly slow down or even be reversed and thus force the recipient country to make sudden, costly and painful macro-economic and financial adjustments. Hence, there are two fundamental concerns about rising foreign capital inflows; one relates to the effective utilization of the resources they provide and the other relates to the appropriate management of the problems associated with the recipient economy's vulnerability to volatile capital flows.

Foreign capital inflows can have both financial (monetary) and real effects in the economy of the recipient country. Starting with the former, the literature suggests that an important trigger for capital inflows is the rate-of-return differential between the recipient country and the rest of the world. The differential attracts foreign investors who are looking for more attractive returns. The resulting foreign-induced demand for domestic stocks leads to a sharp rise in stock prices. The intermediation of this process through the banking system generates an increase in the domestic liabilities of banks; while the higher transactions demand associated with the process also leads to additional bank deposits. The increased bank liabilities will, in turn, stimulate increased bank lending which should put a downward pressure on interest rates. In summary, therefore, economic theory postulates that capital inflows will generate an increase in stock prices, an increase in monetary aggregates and domestic liquidity, and a reduction in domestic interest rates.

While there appears to be broad consensus regarding the impact of capital inflows on key monetary and financial variables, there is a wider range of opinion with respect to their impact on the real sector (Oyejide, 2005). One

general view is that foreign capital inflows provide an opportunity to utilize international resources to supplement limited domestic resources to enhance the growth of the economies of developing countries (Gavin et al, 1997). In this context, foreign capital inflows put to good use can finance investment and stimulate economic growth of the recipient country (Reinhart, 2005). Against this is an opposite view which is derived from empirical analysis; this view shows that capital flows have no significant impact on economic performance once the impact of key variables such as the level of education, initial level of income, and the quality of institutions are controlled for (Rodrik, 1998). An attempt to reconcile these two views is based on the “absorptive capacity” perspective; it suggests that real sector effects of foreign investment on the economy of a recipient country is contingent on key characteristics such as initial income, education and level of financial development. When these characteristics are below certain threshold levels, capital inflows tend to have an ambiguous or even negative effect on growth (Durham, 2000).

Analytical and empirical research provides further insights into the real sector effects of capital flows. For instance, it is well established that capital inflows lead to real exchange rate appreciation because the increased domestic absorption generated by the inflows puts pressure on the non-traded goods sector, and increases its price relative to that of the traded goods sector. The real exchange rate appreciation can, in turn, have positive effects on consumption and investment through at least three channels: increase in the domestic purchasing power of consumers, reduction in the cost of imported capital goods, and fall in the domestic value of debts denominated in foreign currency (Ibarra, 2004). In addition, the real exchange rate appreciation induced by capital inflows is typically associated with a stronger import boom and a relatively weak (if not negative) effect on exports (Celasum et al, 1999).

Capital inflows are usually associated with sharp declines in private domestic savings for at least three reasons. First, the wealth effects of the booming equity and real estate markets induced by capital inflows tend to reduce domestic savings; second, the expansion of bank credit associated with capital inflows relaxes financing constraints of firms and tends to reduce savings; and third, the often excessively optimistic view by domestic consumers of

prospects for the future, induced by capital inflows, results in savings decline.

By comparison, capital inflows may increase investment, to the extent that private investment growth responds positively to the increase in stock prices instigated by the inflows. In summary, therefore, capital inflows tend to be associated with a fall in domestic savings, an increase in private investment and a rise in consumption; a consumption boom which is often heavily driven by rising imports of durable goods. However, the impact of capital flows on the real sector of a low-income country's economy tends to be sensitive to the level of development of its stock market and the banking sector (Durham, 2000).

Beyond this caveat is the much larger issue of the effects of capital flow instability. Significant asymmetries exist with respect to the impact and effectiveness of capital inflows and outflows. In particular, the reduction in total investment and output generated by a given capital outflow tends to be larger than the increase in investment and output induced by capital inflow of the same magnitude. Similarly, while the real exchange rate rises on the inflow of capital, it does not necessarily fall proportionately following an equal capital outflow. In addition, capital inflows and subsequent outflows may shift relative prices in ways which distort resource allocation decisions, and generate abrupt fluctuations in aggregate demand which may raise the level of country risk, depress investment and make government borrowing from abroad more difficult.

Sharp fluctuations in capital inflows can pose significant challenges for economic management by interfering with the effectiveness of government policies and their objectives. In particular, endemic capital flow fluctuations can frustrate attainment of price stability and aggregate demand management in the short-run, as well as constrain economic growth and structural transformation in the medium and long-term. These problems suggest the need for sophisticated management of capital flows and the economy's degree of vulnerability and exposure to capital flow fluctuations.

III. Managing Capital Flows: A Menu of Options

In the 1990s, the search by international investors for more attractive returns on their investments and the economic reforms pursued by a number of emerging market economies combined to produce a surge in capital flows to these countries. As they experienced large capital flows and the associated macroeconomic management challenges, economic research and analysis began to focus increasingly on the question of how to manage these flows not only to maximize their advantages but also to minimize their costs. This effort has given birth to a large and growing literature which generally identifies and discusses policy measures that are aimed at preventing and/or managing capital inflows and their volatility. These policy measures can, obviously, be categorized into two groups. In one group are the policy measures which can be used to prevent instability in capital flows or reduce the economy's vulnerability to capital flow fluctuations. Such policy measures include tax and regulatory policies which are aimed, essentially, at eliminating or reducing the attractiveness of speculative short-term capital inflows while enhancing the inflow of the more stable and long-term FDI. In the second category are policy measures that are aimed at dealing with the instability that may be inevitably associated with capital flows. This category recognizes that there are significant benefits to be derived and there are important costs to be borne. Hence, the policy challenge is to maximize the benefits at a given cost or minimize the costs associated with a given level of benefits. This category thus involves the building of robust institutions and credible policy regimes as well as the appropriate analytical skills and policy-making and implementation capacity.

There is a long list of policy options that is available to countries which wish to manage large capital inflows (see, for instance, Goldstein, 1995). The policy measures that such a country selects from the list would depend on the nature of the inflows, the problems they raise and the particular characteristics and circumstances of the country. In general, the list includes sterilization through open market sales of domestic securities, increase in reserve requirements and tightening of prudential regulations, fiscal tightening, greater nominal exchange rate flexibility, increased liberalization of the trade regime, removal

of restrictions on capital outflows, and tightening of controls on capital inflows.

It is unlikely that any one of these policy measures can single-handedly solve the macroeconomic problems induced by capital inflows. It is therefore not unusual to deploy a mix of tools which may, at a minimum, consist of tight fiscal policy, foreign exchange market intervention, and temporary prudential controls. Calvo and Reinhart (1990) suggest that multiple policy responses to capital inflows in an African context may include the following: the central bank intervenes in the foreign exchange market by accumulating international reserves in an attempt to avoid nominal exchange rate appreciation; and sells treasury bills (or similar domestic debt instrument) to offset the associated monetary expansion; raises the reserve requirements of commercial banks in order to neutralize the effects on the money stock of its foreign exchange operations and thus keep the money stock constant. In addition, there is a supportive fiscal policy component to this package. In particular, fiscal austerity measures on the spending side should alleviate pressures on the real exchange rate; while fiscal surpluses deposited at the central bank would help to sterilize the expansionary monetary effects of the central bank's foreign exchange purchases.

Other policy packages can be constructed with different component parts to reflect both the nature of the problems and the characteristics of the country concerned. The fact of the matter, however, is that none of these policies is a panacea, as each may be associated with significant costs or its implementation may trigger other policy challenges. Hence, whatever packages are chosen, it must be recognized that there will always be difficult trade-offs between the potential short-run costs of large capital inflows and the side-effects of the policy measures used to deal with them. It may be instructive to illustrate some of these side-effects.

Sterilization is often the most popular policy measure taken by countries that experience the macroeconomic management challenges typically associated with large capital inflows. As reserves are accumulated in this process, the fear of inflation leads to a sterilization of the change in reserves so that it does not

affect the domestic money supply by using open market operations. But as the central bank acquires international reserves by issuing domestic debt instruments, other challenges emerge. For instance, domestic interest rate is not under pressure to be driven down; hence interest-rate differential subsists and may induce further capital inflow. Besides, sterilized intervention permits the continued build-up of accumulated reserves; some of which the government may be tempted to spend. In addition, sterilization has quasi-fiscal costs. Since it typically involves the exchange of higher-yielding domestic securities for lower-yielding international assets, a corresponding build-up of quasi-fiscal losses occurs. In any case, sterilization often loses its effectiveness eventually, as the substitutability between domestic and foreign assets increases.

Tightening fiscal policy typically comes along with sterilization, preferably through a reduction in public expenditure. The primary purpose of this is to reduce the pressure on the real exchange rate by lowering domestic absorption and thus limiting the increase in the relative price of non-tradables. But fiscal tightening may also promote capital inflows by signaling that the authorities are committed to prudent macroeconomic management which may, in turn, cause the exchange rate to appreciate, especially over the medium-term. In any case, fiscal tightening is often seen, in the context of these policy packages, as an auxiliary measure to the extent that the required degree of restraint is typically expected to come largely from the side of monetary and exchange rate policy. In addition, fiscal policy lacks short-run flexibility and thus, can not be relied upon for the required policy fine-tuning. Furthermore, there is an inherent conflict between the use of sterilization and fiscal tightening which arises from the quasi-fiscal losses generated by the former. Over the medium-term, the fiscal policy component may assume increased significance if capital inflows reduce monetary policy effectiveness in circumstances where the central bank loses control over key monetary aggregates.

Monetary policy is generally central in the typical policy package aimed at addressing the macroeconomic management challenges caused by large capital inflows. But the potential effectiveness of monetary policy can be substantially eroded by certain features of the financial system that may also be

associated with the occurrence of large capital inflows; i.e., high domestic liquidity, short-term maturity of treasury bills, and increasing share of foreign-currency denominated bank deposits. The impact of the first two of these on the effectiveness of monetary policy are quite obvious, that of the third may benefit from more elaboration. Note, to start with, that as foreign-currency denominated bank deposits increase as a share of broad money, the share of reserve money to GDP tends to fall. In this context, the decreasing size of the monetary base makes expansion more inflationary.

When exchange rate flexibility is included in the mix of policy measures for managing capital flows, the intention is to allow the exchange rate to appreciate in response to large capital inflows, and to permit a greater scope for depreciation in order to discourage speculative inflows. This is not without a significant “downside” effect in the real sector of the economy. More specifically, exchange rate flexibility may lead to a larger real exchange rate appreciation which will, in turn, inhibit export growth while promoting the surge of imports. The imposition of high reserve requirements on commercial banks can adversely affect the allocation of credit by reducing financial intermediation. The tightening of prudential regulations may cause the same kind of problem. The liberalization of capital outflow can send positive signals and thus encourage further capital inflows; while restrictions imposed on various components of capital inflows can be by-passed. Taken together, the various problems associated with the typical packages of standard policy measures that can be used to address the macroeconomic management challenges unleashed by large capital inflows have generated pressures to look in the direction of capital account liberalization for an effective and enduring solution.

IV. The Role and Management of Capital Account Liberalization

In spite of the focus of research and policy analysis on the subject, especially since the Asian crisis of the late 1990s, capital account liberalization remains an issue with respect to which debate continues to rage. Economic theory provides a rationale for capital account liberalization which stresses that free capital mobility promotes an efficient global allocation of savings and a better

diversification of risk; both of these, in turn, stimulate greater economic growth and welfare (Fischer, 1998). The efficiency gains derived from more optimal savings allocation and risk portfolio diversification constitute the major channels through which capital account liberalization is expected to boost economic growth; while the greater consumption smoothening associated with it can be significant for welfare. From the point of view of low-income countries, in particular, capital account liberalization may also be important for attracting foreign investment.

Ranged against this view which broadly supports capital account liberalization is another view which opposes it, both on theoretical and empirical grounds; it is argued, for instance, that the existence of considerable information asymmetry in international financial markets combined with significant domestic distortions means that free capital mobility would not necessarily lead to an optimal allocation of resources (Rodrik, 1998; Stiglitz, 2000). In addition, the magnitude of the gains that may be derived from capital account liberalization is relatively small. Finally, since the empirical evidence linking capital account liberalization to economic growth remains weak, much of the literature continues to question the wisdom of undertaking the clearly costly and risky reforms that are required for capital account liberalization given that the expected benefits to be derived are quite limited and uncertain (IEO, 2005).

Capital account liberalization can play an important role in attracting foreign investment to an economy and in helping to manage the macroeconomic implications of such capital flows. But capital account liberalization is itself associated with risks and distortions. Hence, the management of the process of capital account liberalization requires considerable sophistication in terms of analytical and institutional capacity. This may explain why much of the literature stresses the danger of opening the capital account too rapidly before supporting policies and appropriate institutional capacity are in place.

Because capital account liberalization poses various risks to financial and macroeconomic stability, it should be approached as an integral part of a comprehensive programme of economic reforms (Ishii et al, 2002). Several elements of such a reform package constitute important pre-conditions for

capital account liberalization. According to Galbis (1994), the list of prior reforms includes fiscal consolidation, non-inflationary finance of public deficits, macroeconomic stability, an appropriate monetary-fiscal policy mix, and a strong domestic financial sector. There are, of course, varying views with respect to the relative importance of each of these pre-conditions. Some would argue, for instance, that the most important precondition for capital account liberalization is a comprehensive reform and strengthening of the domestic financial markets and institutions. Others may stress the prior establishment and maintenance of economic stability as the critical pre-condition; while it may also be argued that attaining exchange rate flexibility before capital account liberalization has the advantage of enabling the economy to absorb capital account shocks at lower cost to the real economy. What is clear from the debate on pre-conditions for capital account liberalization is that it should come at the end of a long list of other policy and structural reforms which have been successfully completed and sustained. Hence, there is a fairly broad consensus that capital account liberalization must be viewed as a long-term goal which should be approached gradually, sequentially and systematically.

Stressing that countries should pursue capital account liberalization in a well sequenced and prudent manner, Ishii, *et al* (2002) offer both a set of principles and phases to guide the process. With respect to the sequencing of the liberalization process, the following principles should be applied:

- establish sound macroeconomic policies
- prioritize reforms for sustaining macroeconomic stabilization
- implement together reforms that are operationally linked
- complement financial reforms with prudential regulation and financial restructuring
- take account of concomitant risks of various types of instruments
- reflect the conditions in the non-financial sector in setting the pace of reforms

start reforms which take time early

reforms should take account of the effectiveness of the existing controls

take account of political considerations in establishing the pace, timing and sequencing of capital account liberalization

the arrangements for policy transparency and data disclosure should be adapted to support capital account opening.

In terms of operational strategy, Ishii, *et al* (2002) suggest that the process should start with a diagnosis of the existing institutions and capital account regulations and then proceed through the articulation of a three-stage plan for sequencing and coordinating capital account liberalization with other policies. The goals of the first stage are to achieve a high degree of macroeconomic stability, develop financial markets and institutions, foster good risk management by banks and other economic entities, and remedy the most important shortcomings in prudential regulations. At the end of this stage, capital account liberalization with respect to low-risk capital flows (such as FDI) can be accomplished.

The goals of the second stage consist of consolidation and deepening of the progress made in the first stage. At the end of this stage, considerable further capital account liberalization should take place. The goal of the third and final phase is to ensure that the macroeconomic and financial sector conditions have improved to the point where risks can be effectively managed. At this point, all remaining capital account controls can be lifted.

Neither the general principles nor the operational stages for implementing the capital account liberalization process discussed above mention a critical success factor, i.e., institutional capacity for research and analysis as well as policy design and implementation. It is this which comes into play at several key points when judgments must be made and decisions taken; such as the diagnosis of the pre-liberalization situation, applicability of the general principles, and the goals and time-duration of the operational stages. It is

difficult to over-emphasize the importance of the necessary human and institutional capacity involved.

V. Concluding Comments

Globalization and the capital flows that it generates can bring significant benefits to economies which become more integrated into the global economy. But capital flows and their volatility also pose daunting challenges of macroeconomic management for low-income countries, given the inherent characteristics of their economies, the weaknesses of their economic institutions as well as the associated information asymmetries and policy distortions. Hence, prior cost-benefit analysis may be required before embarking on the process of capital account liberalization to ensure that its uncertain and limited benefits are worth the inherent risks and costs. Beyond this, the process itself must be carefully designed and implemented gradually, sequentially and systematically. The comprehensive reform package in which this process should be embedded will be particularly demanding in the use of sophisticated human and institutional capacity, the build-up of which deserves considerable attention and prioritization.

Selected Bibliography

- Calvo, G. and C. Reinhart (1990), "The Consequences and Management of Capital Flows: Lessons for Sub-Saharan Africa", Almquist & Wiksell, Stockholm
- Calvo, G. (1996), "Inflows of Capital to Developing Countries in the 1990s", *Journal of Economic Perspectives* 10(2), 123 - 29.
- Celasum, O., C. Denizer and D. He (1996), "Capital Flows, Macroeconomic Management, and the Financial System: The Turkish Case, 1989-97", World Bank Working Paper, World Bank, Washington, D.C.
- Corbo, V., and L. Hernandez (1994), "Macroeconomic Adjustment to Capital Flows", World Bank Policy Research Paper 1337, World Bank, Washington, D.C.
- Dooley, M. P. (1996), "A Survey of Literature on Controls over International Capital Transactions", *IMF Staff Papers*, 43, 639 -87.
- Durham, J. B. (2000), "Time-Series Econometrics of the Real and Financial Effects of Capital Flows: Selected Cases in Africa and South-East Asia", QEH Working Paper WPS56, Oxford University, Oxford
- Edison, H. J., M. Klein, L. Ricci, and T. Slok (2002), "Capital Account Liberalization and Economic Performance: Survey and Synthesis", IMF Working Paper 02/120, IMF, Washington, D.C.
- Eichengreen, B. (2001), "Capital Account Liberalization: What Do Cross-Country Studies Tell Us?", *World Bank Economic Review*, 15(3), 341-65
- Fischer, S. (1998), "Capital Account Liberalization and the Role of the IMF" in *Should the IMF Pursue in International Finance*, N0. 207, Princeton University, Princeton

- Galbis, V. (1994), "Sequencing of Financial Sector Reforms: A Review", IMF Working Paper 94/101, IMF, Washington D.C.
- Gavin, M., R. Hausmann, and L. Leiderman (1997), "The Macroeconomics of Capital Flows to Latin America: Experience and Policy Issues", mimeo, Inter-American Development Bank, Washington, D.C.
- Goldstein, M. (1995), "Coping with Too Much of a Good Thing: Policy Responses for Large Capital Inflows in Developing Countries", Policy Research Working Paper 1507, World Bank, Washington, D. C.
- Hanson, J. A. (1992), "Opening the Capital Account: A Survey of Issues and Results", Policy Research Working Paper WPS901, World Bank, Washington, D.C.
- Ibarra, C. (2004), "Capital Flows, Exchange Rate Regime and Macroeconomic Performance in Mexico", Research Paper 2004/27, WIDER, Helsinki
- Independent Evaluation Office (IEO) (2005), "The IMF's Approach to Capital Account Liberalization: Evaluation Report", IMF, Washington, D.C.
- Ishii, S., K. Habermeser, J. Leimore, and J. Vadasz (2002), "Capital Account Liberalization and Financial Sector Stability", IMF Occasional paper 211, IMF, Washington D.C.
- Lopez-Mejia, A. (1999), "Large Capital Flows: A Survey of the Causes, Consequences and Policy Responses", IMF Working Paper 99/17, IMF, Washington, D.C.
- Mathieson, D. J. and L Rojas-Suarez (1993), "Liberalization of the Capital Account: Experience and Issues", Occasional Paper 103, IMF, Washington, D.C.
- Oyejide, T. A. (2005), "Capital Flows and Economic Transformation: A

Conceptual Framework”, Paper prepared for 5th CBN Annual Monetary Policy Conference, Nov 10-11, 2005, Abuja

Reinhart, C. M. (2005), “Some Perspectives on Capital Flows to Emerging Market Economies”, NBER Reporter, Summer 2005, 8-11

Rodrik, D. (1998), “Who Needs Capital-Account Convertibility?”, in Should the IMF Pursue Capital Account Convertibility?, Princeton Essays in International Finance, 207, Princeton

Quirk, P. J. (1994), “Capital Account Convertibility: A New Model for Developing Countries”, IMF Working Paper 94/81, IMF, Washington, D.C.

Stiglitz, J. (2000), “Capital Market Liberalization; Economic Growth and Instability”, *World Development*, 28(6), 1075-86

Stiglitz, J. (2004), “Capital Market Liberalization, Globalization, and the IMF”, *Oxford Review of Economic Policy*, 20(1), 57-71